

# Commercial Bank Examination Manual

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Division of Banking Supervision and Regulation

# Commercial Bank Examination Manual

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Fourth Printing, March 1994

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# Commercial Bank Examination Manual

## Supplement 37—April 2012

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### Summary of Changes

#### *Sections 2000.1, 2000.3, 2000.4, and 4128.1*

Sections 2000.1, 2000.3, and 2000.4 on “Cash Accounts” and section 4128.1, “Private Banking Activities,” were revised to remove outdated references to suspicious activity report filings. In addition, references were made to the Financial Crimes Enforcement Network’s Bank Secrecy Act regulations in the Code of Federal Regulations, Title 31, Chapter X (31 CFR 1010). See SR-11-4 and its attachment.

#### *Section 2040.1*

Section 2040.1, “Loan Portfolio Management,” was revised to incorporate guidance pertaining to institutions’ use of “asset exchanges,” whereby third parties or marketing agents offer to purchase problem assets from institutions and replace with performing assets. The guidance highlights the potential risks that can be associated with these transactions. Such transactions, if properly executed with reputable counterparties and with an appropriate level of due diligence, may reduce nonperforming assets and other real estate owned (OREO). Other such transactions, however, may present significant credit risk to institutions because of a lack of, or inappropriate, due diligence designed to minimize risks over the longer term, including any overvaluations of performing (acquired) assets. The section focuses on (1) how examiners might determine if an institution is engaging in asset exchanges; (2) examiners’ ongoing discussions with management if an institution is considering these types of transactions; (3) whether management has considered the appropriate risk-management measures and if it has used appropriate valuations in accordance with generally accepted accounting principles; and (4) any plans for remedial action to be discussed with management. See SR-11-15 and its attachment.

#### *Sections 2073.1, 2073.2, and 2073.3*

This new section, “ALLL Estimation Practices for Loans Secured by Junior Liens,” is based on

the January 31, 2012, “Interagency Supervisory Guidance on Allowance for Loan and Lease Losses Estimation Practices for Loans and Lines of Credit Secured by Junior Liens on 1–4 Family Residential Properties.” Institutions are reminded to consider all credit quality indicators for junior-lien loans and lines of credit (collectively, junior liens). Generally, this information should include the delinquency status of senior liens associated with the institution’s junior liens and whether the senior liens have been modified. Institutions should ensure that during the allowance for loan and lease loss (ALLL) estimation process sufficient information is gathered to adequately assess the probable loss incurred within junior-lien portfolios. An institution should use reasonably available tools to determine the payment status of senior liens associated with its junior liens, such as credit reports, third-party services, or, in certain cases, a proxy. The guidance applies to all institutions with junior liens. See SR-12-3 and its attachment. The section is supplemented with sections providing examination objectives and examination procedures.

#### *Section 2142.1*

This new section, “Agricultural Credit-Risk Management,” focuses on a bank’s risk-management and capital planning practices when it has significant exposures to market and economic distress from the agricultural sector. It provides supervisory guidance on key risk factors in agricultural lending, and a discussion of potential agricultural market issues and risk ramifications when assessing the adequacy of the risk-management practices and capital needs for a bank’s exposure to agriculture-related risks. The section provides an overview of current and potential agricultural market issues and risk ramifications that banking organizations and supervisory staff should consider in assessing the adequacy of the risk-management practices and capital needs for a banking organization’s exposure to agriculture-related risks. This supervisory guidance also addresses factors that examiners should consider in evaluating individual agriculture-related credits and the adequacy of a banking organization’s practices to monitor a borrower’s capacity to repay given uncertain events. See SR-11-14. This section’s

guidance supplements section 2140.1, “Agricultural Loans.”

### *Section 3000.3*

The “Deposit Accounts” revised examination procedures section removes a reference to Regulation Q, “Prohibition Against Payment of Interest on Demand Deposits,” which was repealed effective July 21, 2011. See section 627 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. See the Board’s press release and 76 *Fed. Reg.* 42015, July 18, 2011.

### *Section A.2040.3*

The section, “Loan Portfolio Management: Comprehensive Mortgage Banking Examination Procedures,” was updated to include additional references to SR-97-21, SR-05-10, and to sections 2040.1, 2040.2, and 2040.3 of this manual. This collective guidance should assist examiners in determining the level of risk associated with a bank’s sale of loans and whether the bank followed appropriate risk-management practices to mitigate those risks.

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### Summary of Changes

#### *Section 2020.1*

The section on “Investment Securities and End-User Activities” was revised to include the Office of the Comptroller of the Currency’s reservation of authority to determine, on a case-by-case basis, that a national bank may acquire an investment security other than an investment security of a type set forth in its regulation (12 CFR 1.1(d)), provided that the bank’s investment is consistent with 12 USC 24 (seventh). (See 73 *Fed. Reg.* 22235, April 24, 2008, and 12 CFR 1.1 for more information). A state member bank should consult with the Board for a determination with respect to the application of 12 USC 24 (seventh) on issues not addressed in 12 CFR 1. The provisions of 12 CFR 1 do not provide authority for a state member bank to purchase securities of a type or amount that the bank is not authorized to purchase under applicable state law. (See 12 CFR 208.21(b).)

#### *Section 2025.1*

This new section, “Counterparty Credit-Risk Management,” is based on the “Interagency Supervisory Guidance on Counterparty Credit Risk Management,” which was issued by the federal banking agencies on June 29, 2011. Counterparty credit-risk (CCR) management is the risk that the counterparty to a transaction could default or deteriorate in creditworthiness before cash flows. The guidance discusses critical aspects of effective management of CCR and sound practices for an effective CCR-management framework. The guidance is intended for use by banking organizations, especially those with large derivatives portfolios, in setting their risk-management practices, as well as by supervisors as they assess and examine such institutions’ management of CCR. The guidance reinforces sound governance of CCR-management practices through prudent board and senior management oversight, management reporting, and risk-management functions. See SR-11-10 and its attachment.

#### *Section 2047.1*

The new section, “Interagency Guidance on Bargain Purchases,” briefly reviews existing accounting and reporting requirements that are unique to business combinations, which result in bargain purchase gains. The principal sources of guidance on business combinations and related measurements under GAAP are found under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 805, *Business Combinations*, and ASC Topic 820, *Fair Value Measurements and Disclosures*. The interagency guidance discusses some of the challenges and responsibilities management has when determining and reporting estimates of the fair-value of assets acquired and liabilities assumed in a business combination. See SR-10-12 and its attachment.

#### *Section 3020.1*

The section on “Assessment of Capital Adequacy” has been revised to briefly summarize and reference the Board’s adoption of the advanced capital adequacy framework (advanced approaches rules), effective April 1, 2008. This section also references the guidance in SR-11-8, “Supervisory Guidance on Implementation Issues Related to the Advanced Measurement Approaches for Operational Risk.” This guidance discusses the combination and use of required data elements and their governance and validation. The section also summarizes the June 14, 2011, revisions to the advanced approaches rule, which established a required permanent capital floor equal to the tier 1 and total capital risk-based capital requirements under the general risk-based capital minimum ratios that apply to insured depository institutions. (See the Board’s press release and 76 *Fed. Reg.* 37620, June 28, 2011.)

#### *Sections 4063.1 and 4063.3*

The section “Electronic Banking” was revised to provide a summary of the various federal banking agency issuances on authentication in an Internet banking environment. It incorporates some of the significant concepts from the June

29, 2011, “Supplement to Authentication in an Internet Banking Environment,” which reinforces existing guidance on customer authentication. The supplement establishes minimum control expectations for high-risk applications and transactions and describes the concept of

layered security programs, which utilize different controls at different points in a transaction process so a weakness in one control is compensated for by the strength of a different control. The examination procedures were revised accordingly. See SR-11-9 and its attachment.

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## Supplement 35—April 2011

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### Summary of Changes

#### *Section 1000.1*

This revised section, “Examination Strategy and Risk-Focused Examinations” includes certain provisions pertaining to charter conversions, changes to corporate powers, and guidance on pre-membership and pre-merger examinations with respect to CRA performance and compliance, and the fiduciary and transfer agent activities of state chartered banks. (See SR-11-2, “Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks.”) The section also was revised to include a provision of SR-11-3, “De Novo Interstate Branching by State Member Banks” regarding the Dodd-Frank Wall Street Reform and Consumer Protection Act. As of July 22, 2010, a state member bank is authorized to open its initial branch in a host state by establishing a de novo branch at any location at which a bank chartered by the host state could establish a branch.

#### *Sections 2020.1, 2070.1, 2072.3, and 2090.1*

The sections on “Investment Securities and End-User Activities,” “Allowance for Loan and Lease Losses,” “ALLL Methodologies and Documentation: Examination Procedures,” and “Real Estate Loans” were revised to include references to SR-11-7, “Guidance on Model Risk Management,” as discussed below for section 4027.1.

#### *Section 2040.1*

The section on “Loan Portfolio Management” was revised to more closely align the guidance and definitions on nonaccrual and past due loans with the bank Call Report instructions. The Financial Accounting Standards Board’s Accounting Standards Codification numeric references are included.

#### *Section 2040.3*

The section on the “Loan Portfolio

Management—Examination Procedures” was revised to update the ratios needed to determine the status of loan portfolio asset quality (that is, ratios involving aggregate past due and nonaccrual loans, classifications, and the allowance for loan and lease losses.)

#### *Section 3000.1*

The section on “Deposit Accounts” was revised to amend the reference to the Financial Crimes Enforcement Network (FinCEN)’s Bank Secrecy Act regulations, now located at 31 CFR Chapter X. (See SR-11-4 and its interagency attachment.) Also, the section briefly discusses a March 24, 2011, interagency advisory—“Guidance on Accepting Accounts from Foreign Embassies, Consulates and Missions.” The section was revised to discuss a bank’s decision on whether to provide account services to foreign missions while complying with the provisions of the Bank Secrecy Act. (See SR-11-6 and its attachment.)

#### *Section 3020.1*

The section, “Assessment of Capital Adequacy” was revised to more closely align the definition of “core capital elements” and the components of qualifying capital with the “Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure” (12 CFR 208 (Appendix A).) The section also was revised to delete (1) the discussions about excluding certain consolidated ABCP programs from the computation of risk-weighted assets and (2) the related exclusion from tier 1 capital—any minority equity interest in a consolidated ABCP program that is not included in risk-weighted assets. See the January 2010, risk-based capital rule change (effective date, March 29, 2010 at 75 *Fed. Reg.* 4636, January 28, 2010. (See also 12 CFR 208, appendix A)).

#### *Section 4027.1*

The new section, “Model Risk Management” was issued jointly by the Federal Reserve Board and Office of the Comptroller of the Currency on April 4, 2011, as “Supervisory Guidance on Model Risk Management.” The



guidance is intended for use by banking organizations and supervisors as they assess organizations' management of model risk. Banking organizations are to be attentive to the possible adverse consequences (including financial loss) of decisions based on models that are incorrect or misused and should address those consequences through active model risk management. The guidance describes in detail the key aspects of an effective model risk-management framework, including robust model development, implementation, and use; effective validation; and sound governance, policies, and controls. (See SR-11-7 and its attachment.)

### *Sections 4030.1 and 4030.3*

The sections on "Asset Securitization," including the examination procedures, have been revised to delete the discussions about excluding (1) certain consolidated asset-backed commercial paper (ABCP) programs from the computation of risk-weighted assets and (2) the related minority equity interests in consolidated ABCP programs. The risk-based capital and leverage rules require banking organizations to include consolidated assets that are held by variable interest entities that are subject to the rules, resulting in their inclusion in their risk-based and leveraged capital ratios.

### *Sections 4140.1, 4140.2, 4140.3, 4140.4, and A.4140.1*

The sections on "Real Estate Appraisals and

Evaluations" were significantly revised to include the December 2010, "Interagency Appraisal and Evaluation Guidelines," and its appendixes. The sections include the revised examination objectives, examination procedures, and the internal control questionnaire. These sections clarify the Federal Reserve's and the other federal bank regulatory agencies' appraisal regulations and highlight the best practices for an institution's appraisal and evaluation programs. The guidelines reflect developments in appraisals and evaluations as well as changes in appraisal standards and advancements in regulated institutions' collateral-valuation methods. The guidelines pertain to all real estate-related financial transactions originated or purchased by a regulated institution or its operating subsidiary for its own portfolio or as assets held for sale, including activities of commercial and residential real estate mortgage operations, capital markets groups, and the securitization of assets and unit sales. Section A.4140.1, consisting of appendixes A through D, was created to capture information related to the interagency guidelines. The appendixes cover the following topics: "Appraisal Exemptions," "Evaluations Based on Analytical Methods or Technological Tools," and "Deductions and Discounts," and include a "Glossary." (See SR-10-16, December 2, 2010, and its attachment.)

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# Commercial Bank Examination Manual

## Supplement 34—October 2010

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### Summary of Changes

#### *Section 2016.1*

This new section provides the April 2010 interagency guidance, “Correspondent Concentration Risks,” including its appendixes, which provide examples of how to compute aggregate credit and funding exposures. The guidance outlines the supervisory agencies’ expectations on sound practices for managing risks associated with credit and funding concentrations arising from correspondent relationships (correspondent concentration risk). Institutions also should identify, monitor, and manage correspondent concentration risk on a standalone and an organization-wide basis. Institutions also should be aware of their affiliates’ exposures to correspondents as well as the correspondents’ subsidiaries and affiliates. The guidance reinforces the supervisory view that financial institutions should perform appropriate due diligence on all credit exposures to, and funding transactions with, other financial institutions. See SR-10-10, April 30, 2010.

#### *Section 4008.1*

This new section conveys the June 25, 2010, interagency “Guidance on Sound Incentive Compensation Policies.” The guidance is based on the following key principles: (1) incentive compensation arrangements at a banking organization<sup>1</sup> should provide employees incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk; (2) these arrangements should be compatible with effective controls and risk management; and (3) these arrangements should be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors. The guidance was issued to help ensure that incentive compensation policies at banking organizations (1) do not encourage imprudent risk taking and

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1. As used in the guidance, the term “banking organization” includes U.S. bank holding companies (BHCs) as well as other institutions supervised by the Federal Reserve.

(2) are consistent with the safety and soundness of the organization. See 75 *Fed. Reg.* 36395, June 25, 2010.

#### *Section 4020.1*

This revised section, “Liquidity Risk,” incorporates, in part, provisions of the March 17, 2010, “Interagency Policy Statement on Funding and Liquidity Risk Management.” The policy statement provides guidance on sound practices for managing the funding and liquidity risks of depository institutions. The guidance explains the process that depository institutions should follow in appropriately identifying, measuring, monitoring, and controlling their funding and liquidity risks. In particular, the guidance re-emphasizes the importance of cash flow projections; diversified funding sources; stress testing; a cushion of liquid assets; and a formal, well-developed contingency funding plan as primary tools for measuring and managing funding and liquidity risks. The interagency guidance also is consistent with the principles of sound liquidity-risk management issued in September 2008 by the Basel Committee on Banking Supervision entitled, *Principles for Sound Liquidity Risk Management and Supervision*.

The Federal Reserve expects all supervised financial institutions to manage their liquidity risk using processes and systems that are commensurate with their complexity, risk profile, and scope of operations. See SR-10-6 and its attachment.

#### *Section 4050.1*

This revised section, “Transactions Between Member Banks and Their Affiliates,” has been supplemented with further staff review comments by the Board’s Legal Division on the provisions of sections 23A and 23B of the Federal Reserve Act (FRA) and the Board’s Regulation W. Sections 23A and 23B of the FRA and Regulation W limit the risks to an insured depository institution (IDI) as a result of transactions between the IDI and its affiliates, including a BHC and its subsidiaries.

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## Supplement 33—April 2010

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### Summary of Changes

#### *Foreword*

The “Foreword” reviews changes in the bank examination environment, the examination processes, and the risk-focused bank examination and supervisory programs; all designed to preserve the safety and soundness of banking organizations.

#### *Preface*

This new “Preface” provides a chronological view into the changing bank legislative and regulatory environment, beginning with the late 1980s. It also provides a discussion of examination processes that have evolved to meet a variety of challenges and responsibilities experienced by examiners on an ongoing basis. These events and actions have contributed to and formed the current banking environment.

#### *Section 1000.1*

The section on “Examination Strategy and Risk-Focused Examinations” has been revised to supplement the examination frequency requirements with the examination frequency standards for a de novo bank or a recently converted state member bank. See SR-91-17.

#### *Section 2200.1*

This section on “Other Real Estate Owned,” has been revised to update its accounting guidance

so that it is in agreement with the bank Call Report’s instructions for acquisitions, holdings, and disposals of all real estate owned, other than bank premises. See this section and the bank Call Report’s instructions for the accounting and reporting standards that apply.

This section also uses references and titles from the Financial Accounting Standards Board (FASB)’s new *Accounting Standards Codification* (ASC) numbering system, which FASB approved in June 2009. The FASB launched the system for its authoritative accounting pronouncements and to reorganize previously existing authoritative literature; all are assigned an “ASC number.” Any other accounting literature not included in the FASB codification is nonauthoritative. Within this section, each first ASC reference is followed by its “pre-codification” FASB reference and title. For more detailed information on the ASC, refer to the December 2009 and March 2010 supplemental instructions to the bank Call Report.

#### *Section 4052.1*

This new section on “Bank Related Organizations” was derived from section 4050.1. Its content has been revised and made into a separate section. The extensive discussions of sections 23A and 23B of the Federal Reserve Act and the Board’s Regulation W remain in section 4050.1, “Transactions Between Member Banks and Their Affiliates.”

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# Commercial Bank Examination Manual

## Supplement 32—October 2009

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### Summary of Changes

#### *Sections 2045.1, 2045.2, 2045.3, and 2045.4*

These new sections discuss “Loan Participations, the Agreements and Participants.” A loan participation is an agreement that transfers a stated ownership interest in a loan to one or more other banks, groups of banks, or other entities. The transferred portion represents an ownership interest in an individual financial asset. The lead bank (transferor) retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. If the transaction satisfies the requirements of Statement of Financial Accounting Standards No. 166 (FAS 166), “Accounting for Transfers of Financial Assets,” an amendment of FASB Statement No. 140, the bank (as transferor) may derecognize the portion of the loan transferred and record a gain on its sale of the participating interests in the loan.<sup>1</sup> Loan participation agreements are helpful to smaller community banks that are trying to satisfy the lending needs of their business customers when they may be constrained by their maximum lending limits.

The sale and purchase of loan participations should adhere to established sound banking practices. Sound controls should include (1) an independent analysis of credit quality by the purchasing bank; (2) an agreement by the lead bank (seller) to make full credit information available about the obligor (borrower) to those acquiring the participating interests in the loan before finalizing the transaction; (3) written documentation fully supporting the transaction, its terms, recourse arrangements, and the rights and obligations of each party; and (4) a docu-

mented analysis as to the value and lien status of collateral pledged on the loan.

The new sections provide one primary location for a discussion of supervisory guidance on loan participation agreements, their terms and components, and the parties involved, as well as the FAS 166 accounting guidance on balance sheet and income statement treatment for such agreements. Examination objectives, examination procedures, and an internal control questionnaire are included.

#### *Sections 2190.1 and 2190.3*

These sections on “Bank Premises and Equipment,” have been revised to clarify the conditions under which a state member bank would be required (based on their respective thresholds) to provide notice to, or obtain the prior approval of, the Federal Reserve for an investment in bank premises under section 24A of the Federal Reserve Act and section 208.21 of the Board’s Regulation H. The sections also discuss certain criteria that a lessor or a lessee would use to determine whether a lease is accounted for as a capitalized lease or an operating lease in accordance with FASB’s Statement of Financial Accounting Standards No. 13 (FAS 13), “Accounting for Leases,” as amended. Updated accounting guidance references also are provided regarding bank leases, including references to the FASB Interpretations that may be useful to examiners regarding FAS 13. The examination procedures section also is revised.

#### *Sections 4020.1, 4020.2, 4020.3, and 4020.4*

The sections, “Asset/Liability Management,” have been revised to assist examiners assessing the liquidity risk of state member banks. The supervisory guidance in these sections replicates the guidance in the “Liquidity Risk” sections (3005.1 - 3005.5) of the *Trading and Capital-Markets Activities Manual*, revised through April 2007. Interagency liquidity guidance (74 Fed. Reg. 32035, July 6, 2009) was issued for public comment until September 4, 2009. The proposed interagency guidance summarizes existing principles of sound liquidity-risk manage-

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1. In June 2009, the Financial Accounting Standards Board (FASB) issued FAS 166, which established conditions for reporting a transfer of a portion (or portions) of a financial asset as a sale. It defines a participating interest as a portion of a financial asset that meets specific criteria, including a requirement that the receipt of loan payments must be distributed on a pro-rata basis. (See paragraph 8.) In addition to meeting the criteria within the definition of a participating interest, loan participations must meet three specific conditions (see paragraph 9) for sale accounting treatment. FAS 166 is effective for the first annual reporting period beginning after November 15, 2009.

ment and, where appropriate, amends these principles to make them consistent with guidance that was issued by the Basel Committee on Banking Supervision in September 2008, entitled, “Principles for Sound Liquidity Risk Manage-

ment and Supervision.” The interagency guidance under development emphasizes supervisory expectations for all domestic financial institutions, including banks. See also the Board’s Press Release of June 30, 2009.

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### Summary of Changes

#### *Section 3020.1*

This section, “Assessment of Capital Adequacy,” was revised to include a reference to the guidance issued in SR-09-1, “Application of the Market-Risk Rule in Bank Holding Companies and State Member Banks.” This guidance assists banks in assessing market risk, but primarily ensures that banks apply the market-risk rule (12 CFR 208, appendix E) appropriately and consistently. The market-risk rule emphasizes the need for appropriate stress testing and independent market-risk management commensurate with the organization’s risk profiles. Banking organizations are to periodically reassess and adjust their market-risk management programs to account for changing firm strategies, market developments, organizational incentive structures, and evolving risk-management techniques. Specifically, SR-09-1 discusses (1) the core requirements of the market-risk rule, (2) the market-risk rule capital computational requirements, and (3) the communication and Federal Reserve requirements in order for a bank to use its value-at-risk measurement models.

#### *Section 4125.1*

This section, “Payment System Risk and Electronic Funds Transfer Activities,” has been revised to update the information on the different types of payment systems such as the Clearing House Interbank Payment System (CHIPS), automated clearinghouse (ACH), and Fedwire Securities Services. On December 19, 2008, the Board adopted major revisions to the “Federal Reserve Policy on Payment System Risk” (PSR policy). Revisions were made to part II of the PSR policy involving intraday credit policies. This section includes this revised guidance, which is designed to improve intraday liquidity management and payment flows for the banking system, while also helping to mitigate the credit exposures to the Federal Reserve Banks from daylight overdrafts. The PSR policy adopts a new approach that explicitly recognizes the role of the central bank in providing intraday balances and credit to healthy depository institutions predominately through zero fee collateral-

ized daylight overdrafts. The section also includes a discussion of adjusting net debit caps and other changes dealing with daylight overdrafts. For more information on the PSR policy changes see the Board’s December 19, 2008, press release. See also 73 *Fed. Reg.* 79109, December 24, 2008.

#### *Sections 5017.1, 5017.2, and 5017.3*

These new sections, “Internal Controls—Procedures, Processes, and Systems (Required Absences from Sensitive Positions),” have been created to assist examiners in evaluating internal controls policies that pertain to procedures, processes, and systems. The sections provide a brief discussion on internal controls, which are the processes developed by a bank’s board and senior management that ensure the institution (1) operates effectively and efficiently, (2) creates reliable financial reports, and (3) complies with applicable laws and regulations.

In particular, the sections discuss requiring absences for two consecutive weeks per year of the bank’s employees that hold sensitive positions. Examples of sensitive activities include trading and wire transfer operations, back-office responsibilities, executing transactions, signing authority, and accessing the books and records of the banking organization. Individuals who can influence or cause such activities to occur should be absent for the minimum period, and the absence should, under all circumstances, be of sufficient duration to allow all pending transactions (those that the absent employee was responsible for initiating or processing) to clear, and to provide for an independent monitoring of those transactions. See SR-96-27.

#### *Sections 7040.1, 7040.2, 7040.3, and 7040.4*

The sections, “International—Country Risk and Transfer Risk,” include the guidance issued in SR-08-12, “Revisions to the Guide to the Interagency Country Exposure Review Committee (ICERC) Process” and its attachments. The new guidance discusses the November 2008 changes to the ICERC country rating process, whose main feature is the rating of countries only when

in default. Default occurs when a country is not complying with its external debt-service obligations or is unable to service the existing loan according to its terms (as evidenced by the failure to pay principal and interest fully and on

time), arrearages, forced restructuring, or roll-overs. The Federal Reserve and the other banking agencies have also eliminated the following rating categories: Other Transfer Risk Problems, Weak, Moderately Strong, and Strong.

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### Summary of Changes

#### *Section 3020.1*

The section “Assessment of Capital Adequacy” is revised to reference (1) the Board staff’s October 12, 2007, legal interpretation regarding the risk-based capital treatment of asset-backed commercial paper (ABCP) liquidity facilities and (2) the Board staff’s August 21, 2007, legal interpretation regarding the appropriate risk-based capital risk weight to be applied to certain collateralized loans of cash.

#### *Section 4030.1*

The section on “Asset Securitization” is revised to (1) indicate that a banking organization may risk weight the credit equivalent amount of an eligible ABCP liquidity facility by looking through to the underlying assets of the ABCP conduit and (2) reference the aforementioned Board staff’s October 12, 2007, legal interpretation.

#### *Sections 4060.1–4060.4*

The sections on “Information Technology” have been revised to incorporate the November 9, 2007, adoption of the interagency rules, “Identity Theft Red Flags and Address Discrepancies Under the Fair and Accurate Credit Transactions Act of 2003,” (the FACT Act) and guidelines issued by the federal financial institution regulatory agencies and the Federal Trade Commission. The rule and guidelines implement sections 114 and 315 of the FACT Act. (For the Federal Reserve Board’s rule, implementing section 315, see Part 222—Fair Credit Reporting (Regulation V and its appendix J). The rule and guidelines address three elements: (1) duties of users of credit reports regarding address discrepancies; (2) duties regarding the detection,

prevention, and mitigation of identity theft (implementation of an Identity Theft Prevention Program); and (3) duties of credit and debit card issuers regarding changes of address. The joint rules and guidelines were effective on January 1, 2008. The date for mandatory compliance with the rule was November 1, 2008. The sections have been revised to incorporate the rule’s provisions that focus on a financial institution’s safety and soundness (in particular, item 2 above). The examination objectives, examination procedures, and internal control questionnaire have been revised to incorporate the rule and its guidelines. See also the October 10, 2008, letter (SR-08-7/CA 08-10) and its interagency-generated attachments.

#### *Section 4150.1*

The section on the “Review of Regulatory Reports” was revised significantly to include a more current discussion of the institution’s general and specific responsibilities, and the examiner’s review responsibilities, with regard to regulatory financial reports and refilings submitted to the Federal Reserve and other federal agencies, such as the Securities and Exchange Commission and the U.S. Department of the Treasury. Many of the reports’ general instructions and descriptions have been revised and made current, including those pertaining to the submission of the bank Call Report. The section clarifies the various monetary deposit transaction reporting categories applicable to depository institutions, as found in the Federal Reserve’s “Reserve Requirements of Depository Institutions” (Regulation D). The report titles and descriptions of domestic and international transactions and activities that are to be reported have been updated. In addition, a listing of U. S. Department of Treasury reports—reports that are applicable to institutions regulated and supervised by the Federal Reserve Board—has been updated.

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# Commercial Bank Examination Manual

## Supplement 29—April 2008

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### Summary of Changes

#### *Section 1000.1*

This section, “Examination Strategy and Risk-Focused Supervision,” has been revised to (1) state that under section 11(a)(1) of the Federal Reserve Act, examiners and supervisory staff have the authority to examine at their discretion the accounts, books, and affairs of each member bank and to require such statements and reports as it may deem necessary; (2) include the use of standard terminology in examination reporting for matters that require the Board’s attention; and (3) provide a discussion of the prohibition on the release of confidential information and any agreements that would authorize the release of this information. (See SR-07-19 and SR-97-17; also 72 *Fed. Reg.* 17, 798.)

#### *Sections 1010.1*

This section on “Internal Control and Audit Function, Oversight, and Outsourcing” was revised to include the provisions of the FDIC’s November 2005 rule change to Part 363 (12 CFR 363) (effective December 28, 2005). The changes increased the asset threshold from \$500 million to \$1 billion or more for internal control assessments by the institution’s management and its external auditors. For institutions having between \$500 million and \$1 billion in assets, the requirements for audit committees’ independence and composition were eased to require a majority, rather than all, of the outside audit committee members to be independent of management. Previously, similar revisions to section 1010.1 were made for some of the

FDIC’s changes. For example, see footnote 4 (See also the May 2006 supplement 25).

#### *Section 5020.1*

The section on “The Overall Conclusions Regarding Condition of the Bank” has been revised to refer to SR-07-19, “Confidentiality Provisions in Third-Party Agreements,” and to delete superseded SR-98-21. The listing of examples of off-balance-sheet activities that a bank may be engaged in, and the various risks that a bank may be exposed to, have been updated and expanded. Reference is added for the Uniform Financial Institutions Rating System (the CAMELS rating system).

#### *Section 6000.1*

The “Commercial Bank Report of Examination” section has been revised to include changes to the Federal Reserve’s examination report’s instructions for the use of standardized terminology that may involve the “Matters Requiring Board Attention” report page or section. To improve the consistency and clarity of written communications, the Federal Reserve’s staff will use the standard terminology and definitions to differentiate among (1) Matters Requiring Immediate Attention, (2) Matters Requiring Attention, and (3) Observations. (See SR-08-01, “Communication of Examination/Inspection Findings.”) Other limited general and technical changes have been made to the examination report’s instructions to allow for “continuous flow” reporting format. References to several Supervision and Regulation letters and other references have been added, while others were deleted as either being superseded or cancelled.

### FILING INSTRUCTIONS

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# Commercial Bank Examination Manual

## Supplement 28—October 2007

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### Summary of Changes

#### *Section 1000.1*

This section, “Examination Strategy and Risk-Focused Supervision,” has been revised to accommodate changes to the “Examination-Frequency Guidelines for State Member Banks” subsection. The changes resulted from an interim rule, effective April 10, 2007, that was jointly issued by the Federal Reserve Board and the other federal bank regulatory agencies (the agencies). The interim rule implemented (1) section 605 of the Financial Services Regulatory Relief Act of 2006 (FSRRA) and (2) Public Law 109-473 (to be codified at 12 USC 1820(d)). The interim rule was adopted as final, without change, on September 11, 2007. (See *72 Fed. Reg.* 54347, September 25, 2007.)

The rule permits federally insured depository institutions that have up to \$500 million in total assets and that meet certain other criteria to qualify for an 18-month (rather than a 12-month) on-site examination cycle. Before the enactment of FSRRA, only insured depository institutions that had less than \$250 million in total assets were eligible for an 18-month on-site examination cycle. The rule specifies, consistent with current practice, that a small insured depository institution meets the statutory “well managed” criteria for an 18-month examination cycle if the institution, besides having a CAMELS composite rating of 1 or 2, received a rating of 1 or 2 for the management component of the CAMELS rating at its most recent examination. (See SR-07-8 and its attachment, *72 Fed. Reg.* 17798.)

#### *Sections 2103.2–2103.4*

These updated sections provide the examination objectives, examination procedures, and internal control questionnaire for section 2103.1, “Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices” (added in the May 2007 update to this manual). Section 2103.1 set forth the December 6, 2006, supervisory guidance that was jointly issued by the agencies. The guidance was effective December 12, 2006, and is applicable to state member banks; it is also broadly applicable to bank

holding companies and their nonbank subsidiaries. (See SR-07-1 and its attachments.)

#### *Section 2135.1*

This new section, “Subprime Mortgage Lending,” sets forth the June 29, 2007, interagency Statement on Subprime Mortgage Lending that was issued by the agencies. The subprime statement was developed and issued to address issues and questions related to certain adjustable-rate mortgage (ARM) products marketed to subprime borrowers. The statement applies to all banks and their subsidiaries as well as to bank holding companies and their nonbank subsidiaries.

The subprime statement emphasizes the need for institutions to have prudent underwriting standards and to provide consumers with clear and balanced information so that both the institution and consumers can assess the risks arising from certain ARM products that have discounted or low introductory rates. The statement is focused on these types of ARMs and uses the interagency Expanded Guidance for Subprime Lending issued in 2001 in order to determine subprime-borrower characteristics. Although the statement is focused on subprime borrowers, the principles in the statement are also relevant to ARM products offered to nonsubprime borrowers. (See SR-07-12 and its attachment.)

#### *Sections 3030.1–3030.4*

These new sections, “Assessing Risk-Based Capital—Direct-Credit Substitutes Extended to Asset-Backed Commercial Paper Programs,” consist of interagency guidance issued in March 2005. That guidance was based on the Board’s adoption of the November 29, 2001, amended risk-based capital standards. The standards established a new capital framework for banking organizations engaged in securitization activities. The interagency guidance clarifies how banking organizations are to use the internal ratings they assign to asset pools purchased by their asset-backed commercial paper (ABCP) programs in order to appropriately risk-weight any direct-credit substitutes (for example, guarantees) that are

extended to such programs. Examination objectives, examination procedures, and an internal control questionnaire are included.

The guidance provides an analytical framework for assessing the broad risk characteristics of direct-credit substitutes that a banking organization provides to an ABCP program it sponsors. Specific information is provided on evaluating direct-credit substitutes issued in the form of program-wide credit enhancements. (See SR-05-6.)

### *Section 4033.1*

This new section, “Elevated-Risk Complex Structured Finance Activities,” sets forth the January 11, 2007, Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities. This supervisory guidance addresses risk-management principles that should help institutions to identify, evaluate, and manage the heightened legal and reputational risks that may arise from their involvement in complex structured financing transactions (CSFTs). The guidance is focused on those CSFTs that may present heightened levels of legal or reputational risk to an institution and are thus defined as “elevated-risk

CSFTs.” Such transactions typically are conducted by a limited number of large financial institutions. (See SR-07-05 and *72 Fed. Reg.* 1372, January 11, 2007.)

### *Section 6010.1*

This section, “Other Types of Examinations,” has been revised to discuss the responsibilities Reserve Bank staff have in the examination and supervision of, and the reporting for, an institution’s compliance with the Government Securities Act. Reserve Bank staff should report only those findings derived from the examinations of government securities broker or dealer operations of state member banks, branches, or agencies subject to Federal Reserve supervision. A Reserve Bank’s staff is required to report separately (to designated Board staff) the results of their reviews of government securities broker-dealer activities (and such broker-dealer’s related custodial activities). The optional reporting form, Summary Report of Examination of Government Securities Broker-Dealer and Custodial Activities, may be used for this purpose. See the specific examination guidance and procedures in SR-06-8, SR-93-40, and SR-87-37. (See also SR-94-5, SR-90-1, and SR-88-26.)

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# Commercial Bank Examination Manual

## Supplement 27—May 2007

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### Summary of Changes

#### *Sections 2010.3, 2040.3, and 4150.1*

The “Due from Banks (Examination Procedures),” “Loan Portfolio Management (Examination Procedures),” and “Review of Regulatory Reports” sections were revised as the result of the Financial Services Relief Act of 2006 (Relief Act) and the Board’s December 6, 2006, approval of an interim rule amendment of Regulation O (effective December 11, 2006). The Relief Act eliminated certain statutory reporting and disclosure requirements pertaining to insider lending by federally insured financial institutions. Sections 215.9, 215.10, and Subpart B of Regulation O were deleted as a result of the rule’s changes. (See 71 *Fed. Reg.* 71,472, December 11, 2006.) The Board approved the final rule for this amendment without change on May 25, 2007 (effective July 2, 2007). (See 72 *Fed. Reg.* 30,470, June 1, 2007.)

#### *Sections 2043.1, 2043.2, 2043.3, and 2043.4*

These new “Nontraditional Mortgages—Associated Risks” sections have been developed based on the September 29, 2006, Interagency Guidance on Nontraditional Mortgage Product Risks. (See SR-06-15.) The guidance addresses both the risk-management and consumer disclosure practices that institutions (for this manual, state member banks and their subsidiaries) should employ to effectively manage the risks associated with closed-end residential mortgage loan products that allow borrowers to defer payment of principal and, sometimes, interest. Examination objectives, examination procedures, and an internal control questionnaire are provided, which should be used when conducting an examination of a bank that is engaged in such lending activities.

#### *Section 2070.1*

This “Allowance for Loan and Lease Losses” section has been fully revised to incorporate the December 13, 2006, Interagency Policy Statement on the Allowance for Loan and

Lease Losses (ALLL). (See SR-06-17.) The guidance updates the 1993 Interagency Guidance on the ALLL (SR-93-70). The revised policy statement emphasizes that each institution is responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses. Each institution should ensure that the adequate controls are in place to consistently determine the appropriate balance of the ALLL in accordance with (1) GAAP, (2) the institution’s stated policies and procedures, and (3) management’s best judgment and relevant supervisory guidance. The policy emphasizes also that an institution should provide reasonable support and documentation of its ALLL estimates, including adjustments to the allowance for qualitative or environmental factors and unallocated portions of the allowance.

#### *Section 2103.1*

A new section, “Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices,” sets forth the December 6, 2006, interagency supervisory guidance, which was issued jointly by the Federal Reserve and the other federal bank regulatory agencies. The guidance, effective December 12, 2006, is applicable to state member banks.

The guidance was developed to reinforce sound risk-management practices for institutions with high and increasing concentrations of commercial real estate loans on their balance sheets. An institution’s strong risk-management practices and its maintenance of appropriate levels of capital are important elements of a sound commercial real estate (CRE) lending program, particularly when an institution has a concentration in CRE or a CRE lending strategy leading to a concentration.

The guidance applies to concentrations in CRE loans sensitive to the cyclicity of CRE markets. For purposes of this guidance, CRE loans include loans where repayment is dependent on the rental income or the sale or refinancing of the real estate held as collateral. The guidance does not apply to owner-occupied

loans and loans where real estate is taken as a secondary source of repayment or through an abundance of caution.

The guidance notes that risk characteristics vary among CRE loans secured by different property types. A manageable level of CRE concentration risk will vary depending on the portfolio risk characteristics and the quality of risk-management processes. The guidance, therefore, does not establish a CRE concentration limit that applies to all institutions. Rather, the guidance encourages institutions to perform ongoing risk assessments to identify and monitor CRE concentrations.

The guidance provides numerical indicators as supervisory monitoring criteria to identify institutions that may have CRE concentrations that warrant greater supervisory scrutiny. The monitoring criteria should serve as a starting point for a dialogue between the supervisory staff and an institution's management about the level and nature of the institution's CRE concentration risk. (See SR-07-1 and its attachments.)

### *Section 3020.1*

The "Assessment of Capital Adequacy" section was revised to include an interim interagency decision on the impact of the Financial Accounting Standards Board's issuance of its September 2006 Statement of Financial Accounting Standards No. 158 (FAS 158), "Employers Accounting for Defined Benefit Pension and Other Postretirement Plans." The decision was announced in a December 14, 2006, joint press release, which was issued by the Federal Reserve Board and the other federal banking and thrift regulatory agencies (the agencies). FAS 158 provides that a banking organization that spon-

sors a single-employer defined benefit postretirement plan, such as a pension plan or health care plan, must recognize the overfunded or underfunded status of each such plan as an asset or a liability on its balance sheet with corresponding adjustments recognized as accumulated other comprehensive income (AOCI). The agencies' interim decision conveys that banking organizations are to exclude from regulatory capital any amounts recorded in AOCI that have resulted from their adoption and application of FAS 158.

### *Sections 2000.4, 2130.3, 4060.1, 4060.4, 4063.4, 4128.1, 4128.3, and 5020.1*

These sections "Cash Accounts (Internal Control Questionnaire)," "Consumer Credit," "Information Technology" (including the internal control questionnaire), "Electronic Banking (Internal Control Questionnaire)," "Private-Banking Activities," (including the examination procedures), and "Overall Conclusions Regarding Condition of the Bank," have been amended for the revised Suspicious Activity Report by Depository Institutions (SAR-DI) form. The Federal Reserve, along with the other federal financial institutions regulatory agencies and the Financial Crimes Enforcement Network (FinCEN), proposed revisions to this form and the instructions in order to (1) enhance their clarity, (2) allow for joint filings of suspicious activity reports, and (3) improve the usefulness of the SAR-DI form to law enforcement authorities. The new form's implementation date has not been determined. Banking organizations subject to SAR filing should continue using the existing SAR-DI format. (See 72 *Fed. Reg.* 23,891, May 1, 2007.)

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# Commercial Bank Examination Manual

## Supplement 26—November 2006

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### Summary of Changes

#### *Sections 2040.1 and 2040.3*

These “Loan Portfolio Management” sections have been revised to incorporate a May 22, 2006, Board staff interpretation of Regulation O pertaining to the use of bank-owned or bank-issued credit cards by bank insiders for the bank’s business purposes. The interpretation is also concerned with the extension of credit provisions and the market-terms requirement of Regulation O when a bank insider uses the bank-owned or bank-issued credit card to acquire goods and services for personal purposes. The examination procedures have been revised to include the provisions of this interpretation.

#### *Sections 3000.1, 3000.2, and 3000.3*

The “Deposit Accounts” sections have been revised to include a brief overview of the Federal Deposit Insurance Corporation’s (FDIC’s) Deposit Insurance System. FDIC’s deposit insurance coverage was amended by the issuance of its March 23, 2006, interim final rules (effective on April 1, 2006). These interim rules implemented certain provisions of (1) the Federal Deposit Insurance Reform Act of 2005 and (2) the Federal Deposit Insurance Reform Conforming Amendments Act of 2005. (See 71 *Fed. Reg.* 14,629.) For deposit accounts, the FDIC’s interim rules provided for (1) inflation (cost-of-living) adjustments to increase the standard maximum deposit insurance amount (SMDIA) of \$100,000 on a five-year cycle, beginning on April 1, 2010; (2) an increase in the FDIC’s SMDIA from \$100,000 to \$250,000 for certain individual retirement accounts, which includes future cost-of-living adjustments; and (3) per-participant FDIC pass-through deposit insurance coverage for employee benefit accounts. (See 12 CFR 330.) The FDIC’s increased insurance coverage of individual retirement accounts also applies to eligible deferred compensation plan accounts.

The “Deposit Accounts” sections also were revised to incorporate the May 11, 2001, Joint Agency Advisory on Brokered and Rate-Sensitive Deposits issued by the federal banking agencies to highlight the potential risks associ-

ated with excessive reliance on such deposits. The advisory provides guidance on prudent risk identification and the management for these types of funding. (See SR-01-14.) The examination objectives and procedures were revised to incorporate the advisory’s guidance.

#### *Section 3020.1*

This section, “Assessment of Capital Adequacy,” was revised to incorporate a general discussion of the risk-based capital treatment of securities-lending transactions (see 12 CFR 208, appendix A, section III.D.1.c). Included is a brief summary of the Board’s February 6, 2006, revision of the Board’s market-risk measure (effective on February 22, 2006). The revision reduced the capital requirements for certain cash-collateralized securities-borrowing transactions of state member banks that adopt the market-risk rule. The action aligns the capital requirements for those transactions with the risk involved. It provides a capital treatment for state member banks that is more in line with the capital treatment that applies to their domestic and foreign competitors. (See Regulation H, 12 CFR 208, appendix E, and 71 *Fed. Reg.* 8,932, February 22, 2006.)

In addition, the revised section includes discussions of the May 14, 2003, and August 15, 2006, Board interpretations that were issued in response to separate inquiries received from the same bank. The May 14, 2003, interpretation concerns an inquiry regarding the risk-based capital treatment of certain European agency securities-lending arrangements that the bank had acquired. For these transactions (the cash-collateral transactions), the bank, acting as agent for its clients, lends its clients’ securities and receives cash collateral in return. It then reinvests the cash collateral in a reverse repurchase agreement for which it receives securities collateral in return. For the cash-collateral transactions, the bank indemnifies its client against the risk of default by both the securities borrower and the reverse repurchase counterparty.

The August 15, 2006, interpretation was also issued in regard to the risk-based capital treatment of certain other securities-lending transactions. For these transactions, the bank, acting as agent for clients, lends its clients’ securities and

receives liquid securities collateral in return (the securities-collateral transactions). The bank indicated that the liquid securities collateral was to include government agency, government-sponsored entity, corporate debt or equity, or asset-backed or mortgage-backed securities. The bank stated that in the event that the borrower defaulted, the bank would be in a position to terminate a securities-collateral transaction and sell the collateral in order to purchase securities to replace the securities that were originally lent. The bank's exposure would be limited to the difference between the purchase price of replacement securities and the market value of the securities collateral. The bank requested that it receive risk-based capital treatment similar to that which the Board had approved and extended to the bank in its letter dated May 14, 2003 (the prior approval).

The Board, using its reservation of authority, again determined that under its current risk-based capital guidelines the capital charge for this specific type of securities-lending arrangement would exceed the amount of economic risk posed to the bank, which would result in capital charges that would be significantly out of proportion to the risk. Referencing the prior approval, the Board approved the August 15, 2006, exception to its risk-based capital guidelines. The bank, which had adopted the market-risk rule, will compute its regulatory capital for these transactions using a loan-equivalent methodology in accordance with the prior approval. In so doing, the bank will assign the risk weight of the counterparty to the exposure amount of all such transactions with the counterparty. The bank must calculate the exposure amount as the sum of its current unsecured exposure on its portfolio of transactions with the counterparty, plus an add-on amount for potential future exposure. This estimated exposure is to be calculated using the bank's VaR model to determine the capital charge for the securities-collateral transactions, subject to the certain specified conditions.

### *Section 4030.1*

The section titled "Asset Securitization" has been revised to incorporate the August 4, 2005, Interagency Guidance on the Eligibility of Asset-Backed Commercial Paper Liquidity Facilities and the Resulting Risk-Based Capital Treatment. The guidance clarifies the application of

the asset-quality test for determining the eligibility or ineligibility of an ABCP liquidity facility and the resulting risk-based capital treatment of such a facility for banks. The guidance also re-emphasizes that the primary function of an eligible ABCP liquidity facility should be to provide *liquidity*—not credit enhancement. An eligible liquidity facility must have an asset-quality test that precludes funding against assets that are (1) 90 days or more past due, (2) in default, or (3) below investment grade, implying that the institution providing the ABCP liquidity facility should not be exposed to the credit risk associated with such assets. The interagency statement indicates that an ABCP liquidity facility will meet the asset-quality test if, at all times throughout the transaction the (1) liquidity provider has access to certain types of acceptable credit enhancements that support the liquidity facility and (2) notional amount of such credit enhancements exceeds the amount of underlying assets that are 90 days or more past due, defaulted, or below investment grade, that the liquidity provider may be obligated to fund under the facility. (See SR-05-13.)

### *Section 4063.1*

The section "Electronic Banking" was revised to incorporate a brief reference to the August 15, 2006, Interagency Questions and Answers (Q&As) for the October 2005 Interagency Guidance on Authentication in an Internet Banking Environment. (See SR-06-13 and SR-05-19.) The Q&As were designed to assist financial institutions and their technology service providers in conforming to the scope, risk assessments, timing, and other issues addressed in the October 2005 guidance that becomes effective at year-end 2006. The section notes, again, that single-factor authentication, as the only control mechanism, is inadequate for high-risk transactions involving access to customer information or the movement of funds to other parties.

### *Sections 4133.1 and 4133.3*

These "Prompt Corrective Action" sections include several changes to more closely align the content to the Board's prompt-corrective-action (PCA) rules. Minor technical amendments that were previously made to the rules (effective on October 1, 1998) are also included.

For example, the definition of total assets was revised to allow the Federal Reserve the option of using period-end rather than average total assets for determining the PCA categories within the rules. (See 63 *Fed. Reg.* 37,630, and 12 CFR 208, subpart D.) The section now includes examination procedures for evaluating compliance with the PCA rules.

*Sections 4140.1, 4140.2, 4140.3, and 4140.4*

The “Real Estate Appraisals and Evaluations” sections have been revised to incorporate the June 22, 2006, interagency statement, The 2006

Revisions to Uniform Standards of Professional Appraisal Practice (USPAP), issued by the federal banking agencies. Under the appraisal regulations, institutions must ensure that their appraisals supporting federally related transactions adhere to USPAP. The interagency statement provides an overview of the USPAP revisions and the ramifications of these revisions to regulated institutions. The 2006 USPAP, effective July 1, 2006, incorporates certain prominent revisions made by the Appraisal Standards Board. These revisions include a new Scope of Work Rule and the deletion of the Departure Rule and some of its associated terminology. (See SR-06-9.)

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# Commercial Bank Examination Manual

## Supplement 25—May 2006

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### Summary Of Changes

#### *Section 1000.1*

This revised section, “Examination Strategy and Risk-Focused Examinations,” reaffirms the definition of the responsible Reserve Bank (RRB) and specifies the RRB’s responsibilities for conducting inter-District examination and supervision activities for a banking organization. The section highlights and clarifies the role of the RRB with respect to inter-District and local Reserve Bank coordination of banking examination and supervision activities. (See SR-05-27/CA-05-11.)

#### *Sections 1010.1, 1010.2, 1010.3, 1010.4, and A.1010.1*

The sections titled “Internal Control and Audit Function, Oversight, and Outsourcing” have been revised to incorporate the February 9, 2006, Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters. The advisory informs financial institutions that it is unsafe and unsound to enter into external audit contracts (that is, engagement letters) for the performance of auditing or attestation services when the contracts (1) indemnify the external auditor against all claims made by third parties, (2) hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution (other than claims for punitive damages), or (3) limit the remedies available to the client financial institution (other than punitive damages). Such limits on external auditors’ liability weaken the auditor’s independence and performance, thus reducing the supervisory agency’s ability to rely on the auditor’s work. The examination objectives, examination procedures, and internal control questionnaire incorporate certain key provisions of the advisory. Section A.1010.1 provides examples of unsafe and unsound limitation-of-liability provisions, and it discusses frequently asked questions and answers that were posed to the Securities and Exchange Commission (Office of the Chief Accountant). The answers confirm that an accountant (auditor) is *not* independent when an

accountant and a client enter into an agreement of indemnity, directly or through an affiliate that seeks to assure the accountant immunity from liability for the accountant’s own negligent acts, whether they are acts of omission or commission. (See SR-06-4.)

#### *Section 1015.1*

This new section, “Conflict-of-Interest Rules for Examiners,” has been developed to inform Federal Reserve System examiners of the System’s policies on maintaining an independent appearance by avoiding conflicts of interest. Examiners must comply with statutory prohibitions and adhere to the System’s rules on conflicts of interest, which are intended to ensure the examiners’ objectivity and integrity. The statutory prohibition (18 USC 213) on accepting any loan or gratuity from any bank under examination is discussed. The limited easing of examiner borrowing restrictions on obtaining credit cards and certain home mortgage loans is also discussed; the easing of these restrictions resulted from the implementation of the Preserving Independence of Financial Institution Examinations Act of 2003 (18 USC 212–213). (See SR-05-2.) The special post-employment restrictions of the Intelligence Reform and Terrorism Prevention Act of 2004 are also reviewed. The Board implemented these restrictions in its November 17, 2005, rule (effective December 17, 2005). (See 12 CFR 263 and 264 and SR-05-26.)

#### *Section 1020.1*

The “Federal Reserve System Bank Watch List and Surveillance Programs” section has been substantially revised to reflect the Federal Reserve’s replacement of the former SEER (the System to Estimate Examination Ratings) surveillance models with a new econometric framework, referred to as the Supervision and Regulation Statistical Assessment of Bank Risk model, or SR-SABR. The SR-SABR model assigns a two-component surveillance rating to each bank. The first component is the current composite CAMELS rating assigned to the bank. The second component is a letter (A, B, C, D, or

F) that reflects the model’s assessment of the relative strength or weakness of a bank compared with other institutions within the same CAMELS rating category. The section describes the new model, details the screening thresholds for SR-SABR within the State Member Bank Watch List program, and updates the watch list follow-up procedures. (See SR-06-2.)

### *Sections 2015.1, 2015.2, 2015.3, and 2015.4*

The new “Interbank Liabilities” sections set forth supervisory guidance that is based on Regulation F (12 CFR 206), which was developed under the authority of section 23 of the Federal Reserve Act (12 USC 371b-2). The Board established standards to limit the risks posed by exposure of insured depository institutions to other depository institutions with which they do business, referred to as *correspondents*. Regulation F applies to FDIC-insured banks, savings associations, and branches of foreign banks (referred to collectively as *banks*). Banks are generally required to have in place internal policies and procedures to evaluate and control the exposure to their correspondents. Regulation F specifies a general “limit,” stated in terms of the exposed bank’s capital, for overnight credit exposure to an individual correspondent. A bank should also ordinarily limit its credit exposure to an individual correspondent to an amount equal to not more than 25 percent of the exposed bank’s total capital, unless the bank can demonstrate that its correspondent is at least “adequately capitalized,” for which no capital limit is specified. A bank is required to establish and follow its own internal policies and procedures for exposure to all correspondents, regardless of its capital level. The rule was effective on December 19, 1992; the Board made technical amendments to the rule on September 3, 2003 (effective September 10, 2003). Examination objectives, examination procedures, and an internal control questionnaire are included. (See SR-93-36.)

### *Section 4042.3*

The accounting considerations within the “Operational Risk Assessment” subsection (examination procedure 3b) were revised to remove the reference to “in excess of 25 percent

of the other assets” threshold for the reporting of the cash surrender value of life insurance assets in the bank Call Report, FFIEC 031, Schedule RC-F item 5, other assets. As of March 31, 2006, this item must be used to report the cash surrender value of *all* life insurance assets.

### *Sections 4050.1 and 4128.1*

Two sections, “Bank-Related Organizations” and “Private-Banking Activities,” were revised to incorporate the Board’s March 15, 2006, approval of an amendment to Regulation K. The amendment incorporates (by reference) section 208.63 of Regulation H into sections 211.5 and 211.24 of Regulation K. As a result, Edge and agreement corporations and other foreign banking organizations (that is, Federal Reserve-supervised U.S. branches, agencies, and representative offices of foreign banks) must establish and maintain procedures reasonably designed to ensure and monitor their compliance with the Bank Secrecy Act and related regulations. (See SR-06-7.)

### *Sections 4128.1, 4128.2, and 4128.3*

The “Private-Banking Activities” section has been further revised to discuss certain borrowing mechanisms that nonresident-alien customers may establish to keep their financial assets in the United States so those assets can be used as operating capital for businesses they own and operate in their home countries. Private bankers need to maintain, in the United States, adequate customer-due-diligence information on such nonresident-alien customers and their primary business interests so that the customer’s home-country government can identify who owns the assets. Examination procedures for private-banking activities (section 4128.3) have also been added.

### *Section 5020.1*

The “Overall Conclusions Regarding Condition of the Bank” section was revised to incorporate the January 20, 2006, Interagency Guidance on Sharing Suspicious Activity Reports with Head Offices and Controlling Companies. The guidance confirms that (1) a U.S. branch or agency of

a foreign bank may disclose a Suspicious Activity Report (SAR) to its head office outside the United States and (2) a U.S. bank or savings association may disclose a SAR to controlling

companies, whether domestic or foreign. Banking organizations must maintain appropriate arrangements for the protection of confidentiality of SARs. (See SR-06-01.)

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# Commercial Bank Examination Manual

## Supplement 24—November 2005

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### LIST OF CHANGES

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<i>Section number</i>	<i>Description of the change</i>
2040.1, 2040.2, 2040.3, 2040.4	The “Loan Portfolio Management” section has been revised to incorporate the May 3, 2005, Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans, which was issued by the Federal Reserve and the other federal supervisory agencies (the agencies). <sup>1</sup> The advisory provides guidance on the appropriate accounting and reporting for both derivative loan commitments (commitments to originate mortgage loans that will be held for resale) and forward loan-sales commitments (commitments to sell mortgage loans). When accounting and reporting for derivative loan commitments, institutions are expected to use generally accepted accounting principles (GAAP). Institutions must also correctly report derivative loan commitments in accordance with the Call Report instructions and forms. (See SR-05-10.) The examination objectives, examination procedures, and internal control questionnaire have been revised to incorporate this interagency advisory.
2090.1, 2090.2, 2090.3, 2090.4	The section “Real Estate Loans” has been revised to include the May 16, 2005, Interagency Credit Risk Management Guidance for Home Equity Lending. The agencies issued the guidance to promote a greater focus on sound risk-management practices at financial institutions that have home equity lending programs, including open-end home equity lines of credit and closed-end home equity loans. The agencies expressed concern that some institutions’ credit-risk management practices for home equity lending had not kept pace with the product’s rapid growth and the easing of underwriting standards for products having higher embedded risk. The guidance highlights the sound risk-management practices an institution should follow to align the growth with the risk within its home equity portfolio. The guidance should also be considered in the context of existing regulations and supervisory guidelines. (See SR-05-11 and its attachment.) The examination objectives, examination procedures, and internal control questionnaire were revised to incorporate the interagency guidance.
3000.1	The “Deposit Accounts” section has been revised to update the statutory and regulatory provisions for a bank soliciting, acquiring, renewing, or rolling over brokered deposits, as those provisions are stated in section 29 of the Federal Deposit Insurance Act (12 USC 1831f) and section 337.6 of the Federal Deposit Insurance Corporation’s brokered-deposit rule (12 CFR 337.6). Section 3000.1 defines and discusses the three capitalization status levels for banks: well capitalized, adequately capitalized, or undercapitalized. These levels determine the extent to which banks may engage in brokered-deposit activities. These definitions are the same as those found in the prompt-corrective-action rules of the FDIC and the Federal Reserve Board. (See 12 CFR 325.103 and 12 CFR 208.43.)

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1. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

Section number	Description of the change
4042.1, 4042.2, 4042.3, 4042.4	<p>The “Purchase and Risk Management of Life Insurance” section has been revised to include appendix C, Interagency Interpretations of the Interagency Statement on the Purchase and Risk Management of Life Insurance (the interpretations). The interpretations have been developed to clarify a variety of matters, including financial reporting, credit-exposure limits, concentration limits, and the appropriate methods for calculating the amount of insurance an institution may purchase.</p> <p>Three new supporting sections provide examination objectives, examination procedures, and an internal control questionnaire. The new sections are based on the Interagency Statement on the Purchase and Risk Management of Life Insurance. (See SR-04-19 and its attachment.)</p>
4128.1	<p>The “Private-Banking Activities” section has been revised to include general and specific references to the relevant supervisory guidance in the June 2005 Federal Financial Institutions Examination Council’s <i>Bank Secrecy Act/Anti-Money Laundering Examination Manual</i>. (See SR-05-12 and its attachments.)</p>
4140.1	<p>The section “Real Estate Appraisals and Evaluations” has been revised to include a summary description of the interagency responses to questions on both the agencies’ appraisal regulations and the October 2003 interagency statement titled Independent Appraisal and Evaluation Functions. The agencies’ March 22, 2005, interpretive responses address common questions on the requirements of the appraisal regulations and the October 2003 interagency statement. (See SR-05-5 and its attachment.) The section has also been revised to include a summary of the September 8, 2005, interagency interpretive responses to frequently asked questions that were issued jointly to help regulated institutions comply with the agencies’ appraisal regulation and real estate lending requirements when financing residential construction in a tract development. (See SR-05-14 and its attachment.)</p>
6003.1	<p>A new section, “Community Bank Examination Report,” provides the examiner with guidance on preparing examination reports for community banks. Developments in technology, the expansion of financial services, and a risk-focused approach to examinations necessitated a need for increased flexibility when organizing and structuring the content of the community bank examination report. Examiners may use certain content headings, which follow a continuous-flow reporting format, or they may use a separate-report-page format. The reporting instructions distinguish between <i>mandatory</i> content (when warranted by the bank’s condition or circumstances) and <i>optional</i> content. The examiner has discretion in the arrangement of certain content. Subject to certain limitations, the examiner may customize and streamline the examination report to better focus on the examiner’s findings involving matters of risk that have a significant impact on the bank’s overall financial condition. This guidance applies <i>only</i> to the preparation of community bank examination reports. (See SR-01-19.)</p>

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# Commercial Bank Examination Manual

## Supplement 23—May 2005

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### LIST OF CHANGES

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<i>Section number</i>	<i>Description of the change</i>
1000.1, 4030.1	The “Examination Strategy and Risk-Focused Examinations” and the “Asset Securitization” sections have been updated to add references to the new bank holding company RFI/C(D) rating system, which became effective January 1, 2005. (See SR-04-18.)
2130.1, 2130.3, 2130.4	The “Consumer Credit” sections have been revised to discuss various types, characteristics, and fee structures of a bank’s ad hoc and automatic overdraft programs. Section 2130.1 includes the February 18, 2005, interagency Joint Guidance on Overdraft Protection Programs that addresses the agencies’ concerns about the potentially misleading implementation, marketing, and disclosure practices associated with the operation of these programs. Financial institutions are encouraged to review their overdraft-protection programs to make certain that their marketing and communications do not mislead consumers or encourage irresponsible consumer financial behavior that could increase the institution’s risk. The guidance also addresses the safety-and-soundness considerations, risk-based capital treatment, and legal risks associated with overdraft-protection programs. (See SR-05-3/CA-05-2.) The examination procedures and the internal control questionnaire have been updated to incorporate this guidance. (See also the summary for sections 3000.1 and 3000.3.) <p>The consumer credit examination procedures have also been updated to include references to and guidance on the Suspicious Activity Report (SAR) and the Bank Secrecy Act (BSA) compliance program. (See sections 208.62–63 of the Board’s Regulation H (12 CFR 208.62–63) and SR-04-8.)</p>
2210.1	The “Other Assets and Other Liabilities” section has been updated to coincide with current accounting guidance and the instructions for the bank Call Report. The section discusses the current examination focus, concerns, and procedures for other assets and other liabilities, as well as their current categories and composition. The section includes the accounting treatment for bank-owned life insurance (BOLI) and an improved discussion of deferred tax assets and deferred tax liabilities (including the risk-based capital limitation on their inclusion in tier 1 capital). For more information on BOLI, see SR-04-4 and SR-04-19.
3000.1, 3000.3	Two of the “Deposit Accounts” sections have been revised to include the February 18, 2005, interagency Joint Guidance on Overdraft Protection Programs that was issued to assist banks in the responsible disclosure and administration of their overdraft-protection services. The policy states that banks should establish and monitor written policies and procedures for ad hoc, automated, or other overdraft-protection programs. A bank’s policies and procedures should be adequate to address the credit, operational, and other risks associated with these types of programs. (See SR-05-3/CA-05-2 and the summary for the 2130 sections.) The examination procedures have been revised to incorporate this supervisory guidance.



Section number	Description of the change
3015.1	A new section, “Deferred Compensation Agreements,” has been added to the “Liabilities and Capital” chapter. The section provides guidance from the February 11, 2004, Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance. The advisory was issued because the agencies, through the examination process, identified many institutions that had incorrectly accounted for obligations under a type of deferred compensation agreement commonly referred to as a <i>revenue-neutral plan</i> or an <i>indexed retirement plan</i> . The advisory informs institutions that they need to review their accounting for deferred compensation agreements to ensure that the agreements have been appropriately measured and reported. (See SR-04-4 and SR-04-19.)
4042.1	A new section, “Purchase and Risk Management of Bank-Owned Life Insurance,” provides the text of the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance. The statement discusses the safety-and-soundness and risk-management implications of purchases and holdings of life insurance by banks. The agencies issued the guidance because they were concerned that some institutions may not have an adequate understanding of the risks associated with BOLI, including its liquidity, operational, reputational, and compliance/legal risks. Further, institutions may have committed a significant amount of capital to BOLI holdings without properly assessing the associated risks. When an institution is planning to acquire BOLI that will result in an aggregate cash surrender value in excess of 25 percent of its tier 1 capital plus the allowance for loan and lease losses, the agencies expect the institution to obtain the prior approval of its board of directors or its designated board committee. The guidance addresses the need for institutions to conduct comprehensive pre- and post-purchase analyses of BOLI, including its unique characteristics, risks, and rewards. Institutions are expected to have comprehensive risk-management processes for their BOLI purchases and holdings; these processes should be consistent with safe and sound banking practices. (See SR-04-4 and SR-04-19.)
4043.1	The “Insurance Sales Activities and Consumer Protection in Sales of Insurance” section has been revised to include the following references: <ul style="list-style-type: none"> <li>• the recently updated discussion on tying arrangements (section 2040.1)</li> <li>• the new BOLI supervisory guidance (section 4042.1)</li> </ul>
4050.1	The “Bank-Related Organizations” section has been revised to incorporate the U.S. Department of the Treasury’s regulation regarding foreign correspondent accounts. The regulation became effective October 28, 2002. (See 31 CFR 103.177 (amended as of December 24, 2002) and 103.185.) The regulation implemented sections 313 and 319(b) of the USA Patriot Act. A covered financial institution (CFI) is prohibited from establishing, maintaining, administering, or managing a correspondent account in the United States for, or on behalf of, a foreign shell bank (a foreign bank that has no physical presence in the United States or other jurisdictions) that is <i>not</i> affiliated (1) with a U.S.-domiciled financial institution or (2) with a foreign bank that maintains a physical presence in the United States or a foreign country and is supervised by its home-country banking authority. A CFI that maintains

*Section number**Description of the change*

a correspondent account for a foreign bank in the United States must maintain records in the United States identifying the owners of the foreign bank. (See SR-03-17 and the attached October 2003 Bank Secrecy Act Examination Procedures for Correspondent Accounts for Foreign Shell Banks; Recordkeeping and Termination of Correspondent Accounts for Foreign Banks. See also SR-01-29.)

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4060.4

The “Information Technology” sections have been revised to include the Board’s December 16, 2004, adoption of rule changes (effective July 1, 2005) that implement section 216 of the Fair and Accurate Credit Transactions Act of 2003 and that amend the Interagency Guidelines Establishing Information Security Standards. (See the Board’s December 21, 2004, press release.) To address the risks associated with identity theft, financial institutions are required to make modest adjustments to their information security programs to develop, implement, maintain, and monitor, as part of their existing information security program, appropriate measures to properly dispose of consumer and customer information derived from credit reports (information maintained in paper-based or electronic form). Each financial institution must contractually require its service providers to develop appropriate measures for the proper disposal of the institution’s consumer and customer information and, when warranted, monitor its service providers to confirm that they have satisfied their contractual obligations.

The sections have also been revised to include the Board’s March 21, 2005, adoption of Jointly Issued Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice. (See the Board’s March 23, 2005, press release.) Financial institutions are to develop and implement a response program designed to address incidents of unauthorized access to sensitive customer information, maintained by the institution or its service provider, that could result in substantial harm or inconvenience to the customer. Each financial institution has the flexibility to design a risk-based response program tailored to the size, complexity, and nature of its operations. Customer notice is a key feature of an institution’s response program. (See Regulation H, appendix D-2, supplement A (12 CFR 208, appendix D-2, supplement A).) The examination objectives, examination procedures, and internal control questionnaire have been updated to incorporate or reference these rule changes and the interagency guidance.

4063.4

The “Electronic Banking: Internal Control Questionnaire” has been updated to include the following references:

- SR-03-12 (and the attached July 2003 SAR form)
- the Board’s Regulation H requirements for suspicious-activity reporting (12 CFR 208.62)
- the Board’s Regulation H requirements for the BSA compliance program (12 CFR 208.63)

See also SR-04-8 and the attached May 24, 2004, Interagency Advisory—Federal Court Reaffirms Protections for Financial Institutions Filing Suspicious Activity Reports.

<i>Section number</i>	<i>Description of the change</i>
4128.1	The “Private Banking” section has been revised to incorporate new and enhanced statutory requirements of the USA Patriot Act. The requirements are designed to prevent, detect, and prosecute money laundering and terrorism. For banking organizations, the act’s provisions are implemented through regulations issued by the U.S. Department of the Treasury (31 CFR 103). Section 326 of the Patriot Act (codified in the BSA at 31 USC 5318(l)) requires financial institutions to have customer identification programs, that is, programs to collect and maintain certain records and documentation on customers. Institutions should also develop and use identity verification procedures to ensure the identity of their customers. SR-04-13 describes the BSA examination procedures for customer identification programs; examiners should follow these procedures when evaluating an institution’s compliance with the regulation. (See also SR-03-17 and SR-01-29.) Relevant interagency interpretive guidance, in a question-and-answer format, addresses the customer identification rules. (See SR-05-9.)
4150.1	The “Review of Regulatory Reports” section has been revised to discuss the termination of the Federal Reserve’s Regulatory Reports Monitoring Program. A less formal program will continue at the Reserve Banks. (See SR-04-15.)
5020.1	The “Overall Conclusions Regarding Condition of the Bank” section has been revised to include guidance on a bank’s use of the SAR form and the filing of a SAR with the Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN). A bank’s record-retention requirements for documentation supporting a SAR are also discussed. (See section 208.62 of the Board’s Regulation H (12 CFR 206.62) and SR-04-8.) In addition, the section has been revised to include the February 28, 2005, Interagency Advisory on the Confidentiality of the Supervisory Rating and Other Nonpublic Supervisory Information. The advisory reminds banking organizations of the statutory prohibitions on the disclosure of supervisory ratings and other confidential supervisory information to third parties. (See SR-05-4.)
7000.0	The “International” section has been revised to convey an overview of the examination focus for international banking transactions and activities. The discussion of other examination topics and Federal Reserve System and FFIEC examination manuals has been updated for those international areas that may be need to be reviewed during a bank examination.
7000.1	The former “International—General Introduction” section has been renamed “International—Examination Overview and Strategy.” The revised title better reflects the content of the sections that follow, which provide the examination and supervisory guidance for international transactions, activities, and international banking. References and other section titles were also updated.

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# Commercial Bank Examination Manual

## Supplement 22—November 2004

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### LIST OF CHANGES

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<i>Section number</i>	<i>Description of the change</i>
1000.1	The “Examination Strategy and Risk-Focused Examinations” section incorporates a May 2004 recommended-practices document promulgated by the interagency State-Federal Working Group. The working group consists of state bank commissioners and senior officials from the Federal Reserve and the Federal Deposit Insurance Corporation. <sup>1</sup> The recommended practices highlight the importance of communication and coordination between state and federal banking agencies in the planning and execution of supervisory activities over state-chartered banking organizations. The recommended practices are the common courtesies and practices examination and supervisory staff are to follow in the implementation and execution of their agencies’ supervisory activities. These recommended practices further reinforce the long-standing commitment of federal and state banking supervisors to provide efficient, effective, and seamless oversight of state banks of all sizes. The practices apply to institutions that operate in a single state or in more than one state. (See SR-04-12.)
2020.1, 2020.3	The “Investment Securities and End-User Activities” section has been updated to include the revised Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts (the uniform agreement) that was jointly issued by the federal banking and thrift agencies (the agencies) on June 15, 2004. The revised uniform agreement amends the 1938 classification of securities agreement (the 1938 accord), which was revised on July 15, 1949, and May 7, 1979. The uniform agreement sets forth the definitions of the classification categories and the specific examination procedures and information for classifying bank assets, including securities. The classification of loans in the uniform agreement was not changed by the June 2004 revision. The revised uniform agreement addresses, among other items, the treatment of rating differences, multiple security ratings, and split or partially rated securities. It also eliminates the automatic classification for sub-investment-grade debt securities. (See SR-04-9.) The examination procedures were also revised to incorporate the supervisory guidance provided in the revised uniform agreement.
2040.1, 2040.2, 2040.3	The “Loan Portfolio Management” section has been revised to incorporate a detailed discussion on tying arrangements. Section 106 of the Bank Holding Company Act Amendments of 1970 generally prohibits a bank from conditioning the availability or price of one product or service (the <i>tying product</i> , or the <i>desired product</i> ) on a requirement that a customer obtain another product or service (the <i>tied product</i> ) from the bank or an affiliate of the bank. Section 106 prevents banks from using their market power over certain products (specifically credit) to gain an unfair competitive advantage in other products.

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1. The source for the recommended-practices document is the November 14, 1996, Nationwide State and Federal Supervisory Agreement (the agreement) to enhance the overall state-federal coordinated supervision program for state-chartered banks. The agreement provides for the supervision of state-chartered banks that have interstate branches. (See SR-96-33.)

*Section number**Description of the change*

Section 106 also prohibits a bank from conditioning the availability or price of one product on a requirement that a customer (1) provide another product to the bank or an affiliate of the bank or (2) not obtain another product from a competitor of the bank or from a competitor of an affiliate of the bank. For example, the statute prohibits a bank from requiring that a prospective borrower purchase homeowners' insurance from the bank or an affiliate of the bank to obtain a mortgage loan from the bank. Section 106 contains several exceptions to its general prohibitions, and it authorizes the Board to grant, by regulation or order, additional exceptions from the prohibitions when the Board determines an exception "will not be contrary to the purposes" of the statute.

Under the federal banking laws, a subsidiary of a bank is considered to be part of the bank for most supervisory and regulatory purposes. Therefore, the restrictions in section 106 generally apply to tying arrangements imposed by a subsidiary of a bank in the same manner that the statute applies to the parent bank itself. Thus, a subsidiary of a bank is generally prohibited from conditioning the availability or price of a product on the customer's purchase of another product from the subsidiary, its parent bank, or any affiliate of its parent bank. Section 106 generally does not apply to tying arrangements imposed by a nonbank affiliate of a bank.

In addition to the regulatory prohibitions and exceptions, this section includes the Board or Board staff interpretations on tying arrangements, including those issued on August 18, 2003, and February 2, 2004. These two interpretations state that bank customers that receive securities-based credit can be required to hold their pledged securities as collateral at an account of a bank holding company's or bank's broker-dealer affiliate. The examination objectives and examination procedures have also been revised to address tying arrangements.

3000.1,  
3000.2,  
3000.3,  
3000.4

The "Deposit Accounts" section has been revised to incorporate the June 15, 2004, interagency advisory "Guidance on Accepting Accounts from Foreign Governments, Foreign Embassies, and Foreign Political Figures." The advisory was issued by the federal banking and thrift agencies (the agencies) and the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN). The advisory was issued in response to inquiries the agencies and FinCEN received on whether financial institutions should do business and establish account relationships with the foreign customers cited in the advisory. Banking organizations are advised that the decision to accept or reject such foreign-account relationships is theirs alone to make. Financial institutions are to be aware that there are varying degrees of risk associated with these accounts, depending on the customer and the nature of the services provided. Institutions should take appropriate steps to manage these risks, consistent with sound practices and applicable anti-money-laundering laws and regulations. (See SR-04-10.) The examination objectives, examination procedures, and internal control questionnaire were also revised to incorporate the advisory's supervisory guidance.

3020.1,  
3020.3

The "Assessment of Capital Adequacy" section has been updated to include provisions of a final rule revision pertaining to a bank's risk-based capital requirements for asset-backed commercial paper (ABCP) programs. The

## Section number

## Description of the change

Board approved the rule changes on July 17, 2004 (effective September 30, 2004). See appendix A of Regulation H (12 CFR 208, appendix A).

In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46, “Consolidation of Variable Interest Entities” (FIN 46). FIN 46 required, for the first time, the consolidation of variable interest entities (VIEs) onto the balance sheets of companies deemed to be the primary beneficiaries of those entities. In December 2003, FASB revised FIN 46 as FIN 46-R. (The interpretation (FIN 46 or FIN 46-R) was effective for reporting periods that ended as early as December 15, 2003. However, there are various effective dates, which are determined on the basis of the nature, size, and type of business entity.) FIN 46-R requires the consolidation of many ABCP programs onto the balance sheets of banking organizations.

Under the Board’s revised risk-based capital rule, a bank that qualifies as a primary beneficiary and must consolidate an ABCP program that is defined as a variable interest entity under generally accepted accounting principles may exclude the consolidated ABCP program’s assets from risk-weighted assets provided that it is the sponsor of the program. Banks must also hold risk-based capital against eligible ABCP liquidity facilities with an original maturity of one year or less that provide liquidity support to ABCP by applying a new 10 percent credit-conversion factor to such facilities. Eligible ABCP liquidity facilities with an original maturity exceeding one year remain subject to the rule’s current 50 percent credit-conversion factor. Ineligible liquidity facilities are treated as direct-credit substitutes or recourse obligations, which are subject to a 100 percent credit-conversion factor. When calculating the bank’s tier 1 and total capital, any associated minority interests must also be excluded from tier 1 capital. The examination procedures were also revised to incorporate the revised risk-based capital requirements.

4030.1,  
4030.2,  
4030.3,  
4030.4

The “Asset Securitization” section has been revised to incorporate the Board’s July 17, 2004, approval (effective September 30, 2004) of a final rule to the risk-based capital requirements for ABCP programs and their liquidity facilities. For more details, see the summary for section 3020.1. The examination objectives, examination procedures, and internal control questionnaire were also revised to incorporate the revised rule for ABCP programs.

4125.1,  
4125.3

The “Payment System Risk and Electronic Funds Transfer Activities” section incorporates the Board’s September 22, 2004, changes to its Policy on Payments System Risk (the PSR policy). (See 69 *Fed. Reg.* 57917, September 28, 2004, and 69 *Fed. Reg.* 69926, December 1, 2004.) Effective July 20, 2006, the PSR policy requires Reserve Banks (1) to release interest and redemption payments on securities issued by government-sponsored enterprises (GSEs) and certain international organizations (institutions for which the Reserve Banks act as fiscal agents but whose securities are not obligations of, or fully guaranteed as to principal and interest by, the United States) only if the issuer’s Federal Reserve account contains sufficient funds to cover them and (2) to align the treatment of the general corporate account activity of GSEs and certain international organizations with the treatment of



*Section number**Description of the change*

the activity of other account holders that do not have regular access to the discount window and those account holders not eligible for intraday credit. The examination procedures have also been updated to incorporate the revisions to the Board's PSR policy.

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# Commercial Bank Examination Manual

## Supplement 21—May 2004

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### LIST OF CHANGES

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<i>Section number</i>	<i>Description of the change</i>
1010.1	This revised section on internal control and audit function, oversight, and outsourcing incorporates a brief overview of the joint final rules adopted by the Board and the other federal bank and thrift regulatory agencies. (See the Board's August 8, 2003, press release.) Section 36 of the Federal Deposit Insurance Act, as implemented by 12 CFR 363, governs the agencies' authority to take disciplinary actions against independent accountants and accounting firms that perform audit and attestation services required by the act. Attestation services address management's assertions concerning internal controls over financial reporting. An insured depository institution must include the accountant's audit and attestation reports in its annual report. The joint final rules established the practices and procedures under which the agencies can, for good cause, remove, suspend, or bar an accountant or firm from performing audit and attestation services for federally insured depository institutions with assets of \$500 million or more. The rules became effective October 1, 2003.
2040.1, 2040.3, A.2040.3	Two of the loan portfolio management sections were revised to provide references to accounting pronouncements that apply to mortgage banking transactions and activities and that are consistent with the bank call report instructions. Comprehensive mortgage banking examination procedures are provided in the new section A.2040.3 (in the appendix to the manual). The comprehensive procedures address the examination, supervisory, and valuation concerns discussed in the following guidance: the February 25, 2003, Interagency Advisory on Mortgage Banking; SR-03-4, "Risk Management and Valuation of Mortgage Servicing Assets Arising from Mortgage Banking Activities"; the mortgage banking examination modules; and many of the mortgage banking inspection (examination) procedures found in section 3070.0 of the <i>Bank Holding Company Supervision Manual</i> .
2070.1	This section on the allowance for loan and lease losses (ALLL) was revised to include references to updated accounting guidance, SR-04-5, and the March 1, 2004, interagency Update on Accounting for Loan and Lease Losses. The interagency update covers recent developments in accounting, current sources of generally accepted accounting principles, and supervisory guidance that applies to the ALLL. Other SR-letters associated with the supervisory guidance for the ALLL are referenced. (See also section 2072.1.)
2100.1, 2100.4	The section on real estate construction loans and the respective internal control questionnaire were revised to incorporate the October 27, 2003, interagency statement on Independent Appraisal and Evaluation Functions and, to a limited extent, the supervisory guidance in SR-03-18. (See the summary for section 4140.1 below.)
4050.1	The section on bank-related organizations was revised to include brief definitions and descriptions of the limited activities and services authorized in Regulation K for foreign bank offices and organizations (that is, foreign bank branches, agencies, commercial lending companies, representative

*Section number**Description of the change*

offices, and correspondent banks). For the purposes of sections 23A and 23B of the Federal Reserve Act, the definition of affiliate was also clarified and expanded on the basis of the provisions of the Board's Regulation W.

4140.1,  
4140.3,  
4140.4

The section on real estate appraisals and evaluations and the respective examination procedures and internal control questionnaire were revised to reference and incorporate the October 27, 2003, interagency statement on Independent Appraisal and Evaluation Functions. A banking institution's board of directors is responsible for reviewing and adopting policies and procedures that establish and maintain an effective, independent real estate appraisal and evaluation program (the program) for all of its lending functions. Concerns about the independence of appraisals and evaluations arise from the risk that improperly prepared appraisals may undermine the integrity of credit-underwriting processes.

An institution's lending functions should not have undue influence that might compromise the program's independence. Institutions may not use an appraisal prepared by an individual who was selected or engaged by a borrower. Likewise, institutions may not use "readdressed appraisals"—appraisal reports that are altered by the appraiser to replace any references to the original client with the institution's name. Altering an appraisal report in a manner that conceals the original client or intended users of the appraisal is misleading and violates the agencies' appraisal regulations and the Uniform Standards of Professional Appraisal Practice (USPAP). (See SR-03-18.)

4180.1,  
4180.2,  
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4180.4

These new sections discuss the January 5, 2004, Interagency Policy on Banks/Thriffs Providing Financial Support to Funds Advised by the Banking Organization or Its Affiliates. The policy alerts banking organizations, including their boards of directors and senior management, to the safety-and-soundness implications of and the legal impediments to a bank providing financial support to investment funds advised by the bank, its subsidiaries, or affiliates (that is, an affiliated investment fund).

The interagency policy emphasizes the following three core principles. A bank should not—

- inappropriately place its resources and reputation at risk for the benefit of affiliated investment funds' investors and creditors;
- violate the limits and requirements in Federal Reserve Act sections 23A and 23B and Regulation W, other applicable legal requirements, or any special supervisory condition imposed by the agencies; or
- create an expectation that the bank will prop up the advised fund (or funds).

In addition, bank-affiliated investment advisers are encouraged to establish alternative sources of financial support to avoid seeking support from affiliated banks. A bank's investment advisory services can pose material risks to the bank's liquidity, earnings, capital, and reputation and can harm investors, if the risks are not effectively controlled. Bank management is expected to notify and consult with its appropriate federal banking agency before (or, in an emergency, immediately after) providing material financial support to an affiliated investment fund. (See SR-04-1.) Examination

*Section number**Description of the change*

objectives, examination procedures, and an internal control questionnaire have been provided to address the supervisory concerns set forth in the policy.

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## THE CHANGING BANK EXAMINATION ENVIRONMENT

The banking industry continues to be increasingly complex. The changing banking and economic environment may reflect potential risks posed to financial institutions and their subsidiaries, bank-related organizations, consumers, and the public. Other risks may be posed by other types of entities and their subsidiaries, competitors, stakeholders, and other outside third parties. To address the risks, complexity, and competitiveness of the banking industry, Congress and state governments continually approve legislation, and their bank regulatory agencies develop and approve the implementing or other new regulations, all to safeguard the safety and soundness of banks and bank-related organizations. The preface of this manual includes a chronological summary of significant legislative, regulatory, and supervisory policies and guidance that have been disseminated to Federal Reserve-supervised institutions beginning from the late 1980s and that have formed the current environment within which these institutions operate.

As part of the Federal Reserve's supervisory process, the banking institution's board of directors or senior management may be requested to initiate various forms of corrective action that may be the result of a supervisory examination or supervisory contact to assure the bank's compliance with federal statutes, regulations, or supervisory policies of the Federal Reserve Board and other federal financial institution regulatory agencies. Banks, bank supervisory agencies and their examiners, and other supervisory staff are constantly confronted with a changing operating environment. Examiners must continually remain alert to unforeseen and unnecessary risks that are posed to, or by, the financial institutions and other bank-related organizations that they may, or may not, supervise and examine. Certain types of activities, transactions, or practices that the bank or other institutions engage in can pose significant risks. The bank's board of directors and senior management are responsible for being aware of, implementing, maintaining, and monitoring adequate internal controls over those risks.

## EXAMINATION PROCESS

The state member bank examination process is the Federal Reserve's fact-finding arm in discharging its regulatory and supervisory responsibilities. The essential objectives of an examination are (1) to provide an objective evaluation of a bank's soundness, (2) to determine the level of risk involved in the bank's transactions and activities, (3) to ascertain the extent of compliance with banking laws and regulations, (4) to permit the Federal Reserve to evaluate the adequacy of corporate governance and to appraise the quality of the board of directors and management, and (5) to identify those areas where corrective action is required to strengthen the bank, improve the quality of its performance, and enable it to comply with applicable laws, regulations, and supervisory policies and guidance. Examiners should also evaluate and determine the prudence of the bank's practices.

An examination's scope is primarily risk-focused but may cover every phase of banking activity, or it may concentrate on specific areas that deserve greater emphasis because of their potential effect on a bank's soundness. The scope and planning for a bank's examination is an integral and important part of the overall examination process. With the enactment of new laws and regulations and the issuance of additional guidance, the scope of an examination continually expands to ensure that all new and existing functional risk areas of a bank are adequately reviewed. New laws, regulations, supervisory policies, guidance, and interpretations result from emerging issues within the banking industry or are tied to specific industry events.

To assess the bank's performance and summarize its overall condition, examiners use the Uniform Financial Institutions Rating System (UFIRS), which is commonly referred to as the CAMELS rating system. The examiner's primary objectives are to evaluate the (1) quality and adequacy of the bank's capital (C); (2) the quality of the bank's assets (A); (3) the capability of the board of directors and management (M) to identify, measure, monitor, and control the risks of the bank's activities and to ensure that the bank has a safe, sound, and efficient operation that is in compliance with applicable laws and regulations; (4) the quantity, sustainability, and trend of the bank's earnings (E);

(5) the adequacy of the bank's liquidity (L) position; and (6) the bank's sensitivity (S) to market risk—the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect the bank's earnings, capital, and liabilities subject to market risk. Once this process is completed, examiners will have the basis for rating the CAMELS components, which, in turn, provide the basis for assigning the bank's overall composite rating. Evaluations of the components are to take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile. During the examination, examiners evaluate the nature of the bank's operations, the adequacy of the bank's internal controls and its internal audit function, and the bank's compliance with laws and regulations.

## RISK-FOCUSED EXAMINATION PROCESS

The Federal Reserve began to further emphasize the importance of sound risk-management processes and strong internal controls in the mid-1990s when evaluating the activities of state member banks. There was an increased emphasis on establishing, maintaining, and monitoring of internal controls. System examination staff were also instructed to assign a formal supervisory rating to the adequacy of a state member bank's risk management and internal control processes. The greater focus on risk management did not diminish the importance of assessing the CAMELS components. Rather, the rating of risk management summarized much of the analysis and findings regarding the member bank's process for monitoring and controlling risks in these other key areas. As a result, the assigned risk-management rating highlights and incorporates further the qualitative and quantitative aspects of the examiners' review of the bank's overall process for identifying, measuring, monitoring, and controlling risk throughout the institution.

Greater emphasis on risk-focused supervision continued in 1997 when the Federal Reserve introduced its risk-focused framework for the supervision of large complex institutions. Supervisory processes were designed to focus more effectively on an organization's primary risks and internal controls and the processes for

managing and monitoring principal risks. The framework pertained to institutions with a functional management structure and a broad array of products, services, activities, and operations. This program is managed by an assigned central point of contact (CPC), assisted by a dedicated team of examiners who conduct target reviews of functional areas and product lines during a supervisory cycle.

A supervisory framework also was begun for community banks. The framework relies on examiner judgment when determining the scope of the examination during the planning process. Examiners are able to customize the examination procedures to be performed on-site at the bank. The examiner-in-charge (EIC) outlines the risk profile of the bank and the examination activities.

## ABOUT THIS MANUAL

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

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

The CPC or EIC must properly plan and organize the examination before work begins.



Initial decisions concerning examination scope can usually be made based on the nature of the bank's operations; its size; the past experience of the CPC or EIC with the bank; the previous examination report's information, including the condition of the bank at that examination; communications with the bank (e.g., the board of directors and senior management) between examinations; and analysis of the information derived from the bank's Uniform Bank Performance Report, Call Report, or off-site surveillance screening of data. The planning of work and pre-examination procedures are covered in the Examination Planning section of this manual.

The manual is also intended to guide examiners in their efforts to encourage banks to develop written policies and related procedures in all areas where none exist, and to correct situations where there are deficiencies in, or a lack of compliance with, existing procedures. To aid examiners, this manual includes topics such as loan portfolio management, investment portfolio management, asset and liability management, earnings analysis, capital analysis, and service area analysis. A section on the appraisal of bank management guides examiners in assembling and evaluating information from all other manual sections and helps uncover inconsistencies in the application of bank policies among various management groups. Examiners should be able to increase the level of professionalism and the soundness of the banking system by encouraging all banks to follow the best practices that currently exist in the banking industry. However, this approach should not discourage the development and implementation of conceptually sound and innovative practices by individual banks.

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

Examiners should view the manual as a working tool and guide. In most sections of the manual, examination procedures and internal

control questionnaires are provided to form the basis for a bank examination. These procedures should lead to consistent and objective examinations of varying scope. The bank's condition is disclosed by the performance of the examination procedures, including the review of internal controls and audit function, and the evaluation of the results or findings, not by the examiner's judgment alone.

## HOW TO USE THIS MANUAL

### Organization

The *Commercial Bank Examination Manual* is divided into 10 major parts, separated by divider tabs:

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

Sections in each part are made up of four subsections, where applicable:

- supervisory policy and guidance by topic,
- examination objectives,
- examination procedures, and
- internal control questionnaire

The primary sections summarize and provide details on the respective topics. This information is expanded upon and reinforced through the Federal Reserve's educational and training programs and the examiner's experience on the job.

The examination objectives describe the goals that should be achieved, which should be of primary interest to the examiner. Two of the objectives may determine the scope of the examination for the specific area of examination interest: (1) the evaluation of the system of internal controls and of bank policies, practices, and procedures and (2) the evaluation of the

scope and adequacy of the audit function. Other common objectives are to determine compliance with laws, regulations, supervisory policies, procedures, guidance, and any interpretations, and to determine the need for corrective action.

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

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

Following the main parts of the manual are a listing of statutes and regulations administered

by the Federal Reserve and an appendix that includes various forms, checklists, statements, and guidelines, which provide the examiner with additional information regarding certain topics.

## Numbering System

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

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

## Updates

Subsequent to the March 1994 reprint of this manual, all new or revised manual pages are dated the month and year for which they were issued. There is an effective date at the top of the first page of each section that shows when the section's information was last updated.

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

## THE CHANGING SUPERVISORY EXAMINATION PROCESS, SIGNIFICANT LAWS, REGULATIONS, SUPERVISORY POLICY AND GUIDANCE

In response to new bank legislation and the changing regulatory environment, the examination process has continually evolved to meet a variety of challenges. To understand what challenges and responsibilities examiners may encounter over time, it is necessary to understand (1) what the changes have been, (2) how or when they occurred, and (3) what actions the supervisory agencies have taken to mitigate and control institutions' risk exposures while safeguarding the safety and soundness of banks and the banking system as a whole. To assist with that understanding, a chronological summary of significant legislative, regulatory, and supervisory policies is provided below. These actions, beginning with the late 1980s, have contributed to the current banking environment and the challenges posed to examiners on an ongoing basis.

### 1987

Specific time limits were established for various types of deposits by the Competitive Equality Banking Act. Funds deposited into an account of a depository institution using local and in-state checks are required to be made available the next business day. Funds deposited with all other checks are to be available on the fourth business day after deposit.

### 1989

The federal depository institution supervisory agencies' enforcement powers over the institutions they supervise were expanded by the Financial Institutions Reform and Recovery Act. The legislation included the power to disapprove the appointment of directors and senior officers of certain depository institutions and depository institution holding companies.

### 1991

Supervisory reforms were implemented. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) prohibited insured depository institutions that are not well-capitalized from accepting funds through a deposit broker. Annual on-site examinations and fiscal status reports for all insured depository institutions were required. The annual examination requirement was later revised by the Riegle Community Development and Improvement Act of 1994, which raised the examination frequency to 18 months for smaller banking institutions. These smaller banking institutions were later defined as having less than \$250 million in assets by the Economic Growth and Regulatory Paperwork Reduction Act of 1996. This asset threshold level was further raised to less than \$500 million by the Financial Services Regulatory Relief Act of 2006, subject to certain specific criteria.

FDICIA was enacted, in part, as a less costly resolution for insured banks and to improve their supervision and examination. It required the federal banking agencies to prescribe standards for credit underwriting, loan documentation, and other policies to preserve the safety and soundness of banks. FDICIA established the prompt corrective action (PCA) standards for undercapitalized banks. Based on their level of capitalization, banks are designated as "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," or "critically undercapitalized." A bank's capitalization designation is based on its total capital, tier 1 capital, and tier 1 leverage capital ratios. (See the definitions in 12 CFR 208.41.) Ultimately, the PCA statute was designed to impose mandatory and discretionary restrictions on banks that fall below the "adequately capitalized" level.

### 1995

Effective after the mid 1990s, the Federal Reserve intensified its focus on the importance of sound risk-management processes and practices as well as strong internal controls. System examiners were instructed to more thoroughly evaluate the bank's process for monitoring and controlling risk during an

examination. Examiners began reporting a formal supervisory rating upon the conclusion of an examination pertaining to the adequacy of a bank's risk-management processes and internal controls. The rating provided a summary of the examiner's analysis and findings regarding the bank's overall processes for identifying, measuring, monitoring, and controlling risk. The rating incorporates the qualitative and quantitative aspects of risk management found during the examiners' review. See SR-95-51, "Risk Management and Valuation of Retained Interests Arising from Securitization Activities."<sup>1</sup>

## 1996

The Economic Growth and Regulatory Paperwork Reduction Act of 1996 revised the Federal Reserve Act to permit well-capitalized and well-managed banks to invest amounts equal to 150 percent of capital and surplus in bank premises without prior Federal Reserve approval. The Federal Deposit Insurance Act (FDIA) was amended to mandate that each banking agency take the actions necessary to ensure that examiners consult and reach agreement on examination activities and resultant recommendations. The FDIA was amended to authorize a federal banking agency to permit an independent audit committee to be composed of a majority of outside directors, independent of the institution's management, if it determines that the depository institution has encountered hardships in retaining competent directors on such a committee.

## 1997

The emphasis on risk-focused supervision continued when the Federal Reserve issued SR-97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions." Supervisory processes were developed that focused more effectively on an organization's primary risks

1. Supervision and Regulation letters, commonly known as SR letters, address significant policy and procedural matters related to the Federal Reserve System's supervisory responsibilities. These letters are issued by the Board's Division of Banking Supervision and Regulation and are a means of disseminating information to banking supervision staff at the Board and the Reserve Banks, as well as to supervised banking organizations.

and internal controls, and its process for managing and monitoring principal risks. The framework was designed for institutions with a functional management structure and a broad array of products, services, activities, and operations. This supervisory program is managed by an assigned central point of contact (CPC), assisted by a dedicated team of examiners who conduct target reviews of functional areas and product lines during a supervisory cycle.

More emphasis was given to a risk-focused supervisory framework for community banks. SR-97-25, "Risk-Focused Framework for the Supervision of Community Banks," details a framework that relies on examiner judgment when determining the scope of the examination during the planning process. Examiners are able to customize the examination procedures to be performed on site at the bank. The examiner-in-charge (EIC) outlines the risk profile of the bank and the exam activities.

## 1999

The Gramm-Leach-Bliley Act (GLB Act) amended the Banking Act of 1933. It repealed the prohibitions against (1) a Federal Reserve member bank affiliating with an entity engaged primarily in securities activities (securities affiliate) and (2) the simultaneous service by an officer, director, or employee at a securities firm and also a member bank (interlocking directorates). The statute amended federal banking law so that a national bank (thus, a state member bank) could control or hold an interest in a financial subsidiary. A financial subsidiary's activities are limited to those activities that are (1) financial in nature or incidental to a financial activity or (2) permissible for a national bank to engage in directly. A financial subsidiary is prevented from engaging in certain insurance or real estate development and investment activities.

## 2000

The risk-focused examination program continues with a concept of conducting, when appropriate, a series of targeted examinations within a supervisory cycle, with each examination focusing on an activity, business line, or legal entity. The examiner is also to consider a bank's information technology (IT) systems and con-

trols when developing risk assessments and supervisory plans and when determining the level of examination review needed, given the characteristics, size, business activities, and complexity of the organization. Safety-and-soundness examiners and IT specialists closely coordinate their activities and the level of expertise needed during the risk-assessment and planning phase, as well as during on-site examinations.

The American Homeownership and Economic Opportunity Act of 2000 required the banking agencies to work together to develop (1) electronic filing and public dissemination of depository institution status reports (Call Reports) and (2) uniform formats and simplified filing instructions for Call Reports.

## 2001

Examiners were advised that the GLB Act authorized well-capitalized state member banks to deal in, underwrite, purchase, and sell municipal revenue bonds without limitations relative to the bank's capital. Federal banking agency expectations were announced for documentation for the Allowance for Loan and Lease Losses (ALLL) methodology. Examiners were informed of the GLB Act's ownership and control provisions, the approval requirements, and permissible activities for financial subsidiaries and operating subsidiaries of state member banks. The GLB Act allowed banks to continue to retain new operations subsidiaries that are permitted under state law.

Examiners were advised of an increased emphasis on the review of a bank's information technology within the examination process. This includes a review of on-site electronic banking activities (new products and services; changes in the composition or level of customers, earnings, assets, or liabilities generated or affected; new or significant modified systems or outsourcing relationships; and business lines that rely heavily on electronic banking systems). Examiners are expected to focus on significant changes in the scope of services and the nature of operations.

## 2002

The Federal Reserve examination and supervisory staff and the financial institutions' board of directors and senior management were advised

of supervisory guidance that was issued for the design and implementation of ALLL methodologies and documentation practices, tailored to the size and complexity of the institution and its loan portfolio. An institution's ALLL methodology must be a thorough, disciplined, and consistently applied process that includes management's current judgment about the quality of the loan portfolio. The institution must maintain, at a minimum, current written supporting documentation for its decisions, strategies, and processes.

Institutions are expected to recognize the elevated levels of credit risk and other risks arising from subprime lending practices. Institutions are to have strong risk-management practices, internal controls, and board-approved policies and procedures that appropriately identify, monitor, and control all risks associated with the activity. Such credit-extending activities necessitate (1) more vigilant risk-management practices and (2) additional capital.

Interpretive guidance was issued on the capital treatment of recourse obligations, direct-credit substitutes, and residual interests in asset securitization due to supervisory concern over the covenants in asset securitization agreements (contracts) that were linked to supervisory thresholds or adverse supervisory actions. A risk-based capital treatment was begun pertaining to a ratings-based qualification for certain corporate bonds or other unrated securities (those that are unrelated to an asset securitization or structured finance program). Guidance was issued on implicit recourse that is provided to asset securitization. The guidance demonstrated that the securitizing institution is reassuming risk associated with securitized assets—risk that the institution initially transferred to the marketplace.

The Sarbanes-Oxley Act (SOX) was enacted. It applies to publicly owned companies, which includes a small number of state member banks. These companies and banks have issued securities registered under section 12 of the Securities Exchange Act of 1934 or are required to file reports under section 15(d) of the 1934 Act. The SOX is concerned with specific mandates and requirements for financial reporting, including auditor independence, conflicts of interest, financial disclosure, corporate governance, criminal fraud, and accountability. Of particular importance for a state member bank is the internal control function, as it relates to auditor independence, financial disclosures, formation of an

audit committee, and the attestation on the adequacy of internal controls. See sections 1010.1 and 4150.1.

## 2003

The Check Clearing for the 21st Century Act established a framework of special conditions under which a substitute check could be the legal equivalent of an original check. The primary considerations of the Fair and Accurate Credit Transactions Act (amended by the Fair Credit Reporting Act) were to prevent identity theft and provide for the restoration of a consumer's credit history. Another supervisory focus included an emphasis on authentication within an electronic banking environment—the assessment of the risks and establishing and maintaining the necessary risk-management measures and controls. Great emphasis was placed on the federal banking agencies issuing regulations that require the proper disposal of consumer information, or any compilation of it, that is derived from consumer reports. Certain institutions are to provide written notice to a consumer if they furnish negative information to a consumer reporting agency on credit extensions.

## 2004

The federal banking agencies adopted joint rules for disciplinary actions that may be taken against independent accountants and accounting firms that perform audit and attestation services that are required by the FDI Act for insured institutions having \$500 million or more in assets. Attestation services address management assertions regarding internal controls over financial reporting.

An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish and maintain an effective independent appraisal and evaluation program for all lending functions in compliance with the 2003 interagency statement on Independent Appraisal and Evaluation Functions.

## 2005

The Federal Deposit Reform Act of 2005 increased the standard maximum deposit insur-

ance from \$100,000 to \$250,000 for certain deposit retirement accounts.

Supervisory guidance was issued on the safety-and-soundness and risk-management implications of an institution's purchases and holdings of life insurance. The guidance was developed and issued in response to a concern that institutions may not have an adequate understanding of the risks associated with bank-owned life insurance (BOLI) holdings, including the liquidity, operational, reputational, and compliance risks. Institutions should not acquire a significant amount of BOLI holdings without properly assessing its associated risks. When an institution acquires BOLI that will result in an aggregate cash surrender value in excess of 25 percent of its tier 1 capital plus the ALLL, the prior approval of the board of directors or designated committee should be obtained. An institution should conduct comprehensive pre- and post-purchase analyses of BOLI, including its unique characteristics, risks, and rewards. There must be comprehensive risk-management processes for the institution's BOLI purchases and holdings, consistent with safe-and-sound banking practices.

Interagency guidance was issued on the Eligibility of Asset-Backed Commercial Paper (ABCP) Liquidity Facilities and the Resulting Risk-Based Capital Treatment. The guidance clarified the application of the asset-quality test for determining the eligibility or ineligibility of an ABCP liquidity facility and the resulting risk-based capital treatment of such a facility for banks. It re-emphasized that the primary function of an eligible ABCP liquidity facility was to provide *liquidity*—not credit enhancement. An eligible liquidity facility must have an asset-quality test that precludes funding against assets that are (1) 90 days or more past due, (2) in default, or (3) below investment grade, implying that the institution providing the ABCP liquidity facility should not be exposed to the credit risk associated with such assets.

## 2007

New standards set forth a revised risk-based capital framework for banking organizations. Institutions are to use internal ratings they assign to asset pools purchased by their asset-backed commercial paper programs. These ratings are used to assign a risk weight to any

direct credit substitutes (such as guarantees) that are extended to such programs. Guidance is provided on evaluating direct credit substitutes that are issued as program-wide credit enhancements.

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### EXAMINATION AND SUPERVISORY AUTHORITY AND CONFIDENTIALITY PROVISIONS

The Federal Reserve System's statutory examination authority permits examiners to review all books and records maintained by a financial institution that is subject to the Federal Reserve's supervision. This authority extends to all documents.<sup>1</sup> Section 11(a)(1) of the Federal Reserve Act provides that the Board has the authority to examine, at its discretion, the accounts, books, and affairs of each member bank and to require such statements and reports as it may deem necessary.

Federal Reserve supervisory staff (includes the examination staff), therefore, may review *all* books and records of a banking organization that is subject to Federal Reserve supervision.<sup>1a</sup> In addition, under the Board's Rules Regarding the Availability of Information, banking organizations are prohibited from disclosing confidential supervisory information without prior written permission of the Board's General Counsel.<sup>1b</sup> Confidential supervisory information is defined to include any information related to the examination of a banking organization.<sup>1c</sup> Board staff have taken the position that identification of information requested by, or provided to, supervisory staff—including the fact that an examination has taken or will take place—is related to an examination and falls within the definition of confidential supervisory information. It is contrary to Federal Reserve regulation and policy for agreements to contain confidentiality provisions that (1) restrict the banking organization from providing information to Federal Reserve supervisory staff;<sup>1</sup> (2) require or permit, without the prior approval of the Federal Reserve, the banking organization to disclose to a counterparty that any information will be or was provided to Federal Reserve supervisory staff; or (3) require or permit, without the prior approval of the Federal Reserve, the banking organization to inform a counterparty of a current or upcoming Federal Reserve examination or any nonpublic

Federal Reserve supervisory initiative or action. Banking organizations that have entered into agreements containing such confidentiality provisions are subject to legal risk. (See SR-07-19.)

### EXAMINATION-FREQUENCY GUIDELINES FOR STATE MEMBER BANKS

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

- have total assets of less than \$500 million;<sup>1d</sup>
- are well capitalized;
- were assigned a management rating of 1 or 2 by the Federal Reserve as part of the bank's rating under the Uniform Financial Institutions Rating System;
- were assigned a composite CAMELS rating of 1 or 2 by the Federal Reserve at their most recent examination;
- are not subject to a formal enforcement proceeding or action; and
- have not had a change in control during the preceding 12-month period in which a full-scope, on-site examination would have been required but for the above exceptions.

(See section 208.64 of Regulation H and 72 *Fed. Reg.* 17798, April 10, 2007, and 72 *Fed. Reg.* 54347, September 25, 2007.) The exceptions do not limit the authority of the Federal Reserve to examine any insured member bank as frequently as deemed necessary. (See also SR-07-8 and SR-97-8.)

<sup>1d</sup> Based on jointly issued interim rules (effective April 10, 2007) issued by the Federal Reserve Board (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). The interim rule was adopted as final, without change, on September 11, 2007. (See 72 *Fed. Reg.* 54347, September 25, 2007.) The interim rules implemented section 605 of the Financial Services Regulatory Relief Act of 2006 (FSRRA) and Public Law 109-473. Previously, the 18-month examination cycle was available only for institutions that had total assets of \$250 million or less.

1. SR-97-17 details the procedure supervisory staff should follow if a banking organization declines to provide information asserting a claim of legal privilege.

1a. Supervisory staff include individuals who are on and/or off site.

1b. 12 CFR 261.20(g).

1c. 12 CFR 261.2(c)(1)(i).

## De Novo Bank Examination Frequency

A de novo bank is a bank that has been in operation for five years or less. A de novo bank or a recently converted state member bank<sup>1c</sup> has a different examination frequency from the required 12-month or 18-month examination schedule. The examination frequency for these banks is found in SR-91-17, “Application and Supervision Standards for De Novo State Member Banks.” Each Reserve Bank should conduct

- a limited scope examination after the bank’s first quarter of operation,
- a full-scope examination six months after the end of the first quarter of operation, and
- a full-scope examination for each six-month interval thereafter until the bank receives two consecutive CAMELS composite ratings of “1” or “2” and, in the judgment of the Reserve Bank, can be expected to continue operating on a sound basis.

Once these criteria are met, the standard examination schedule may be followed.

If a bank’s composite rating becomes a CAMELS “3” or worse (after two consecutive composite ratings of “2” or better) at any time during the first five years of operation, the Reserve Bank should, thereafter, conduct a full-scope examination at six-month intervals until the composite rating is a “2” or better for two consecutive examinations. If the Reserve Bank staff are of the opinion that the bank will continue to operate on a sound basis, the standard examination schedule may be followed.

### *Exception to De Novo State Member Bank Examination Frequency—Bank Subsidiaries of Large Bank Holding Companies*

Examination frequency guidelines may be waived for de novo state member bank subsidiaries of large bank holding companies (consolidated assets greater than \$1 billion) if the Reserve

1c. This policy applies to commercial banks that have been in existence for less than five years and subsequently convert to membership. Thrifts, Edge Act corporations, industrial banks that are converting to membership, irrespective of their length of existence, are also subject to the de novo policy because they have not demonstrated operating stability as a commercial bank.

Bank determines that the parent company and its subsidiary banks are in satisfactory condition and the parent is considered to be a source of strength to the bank subsidiaries.

## Alternate-Year Examination Program

The frequency of examination may also be affected by the alternate-year examination program. Under the alternate-year examination program, those banks that qualify are examined in alternate examination cycles by the Reserve Bank and the state. Thus, a particular bank would be examined by the Reserve Bank in one examination cycle, the state in the next, and so on. Any bank may be removed from the program and examined at any time by either agency, and either agency can meet with a bank’s management or board of directors or initiate supervisory action whenever deemed necessary.

Banks that are ineligible for an alternate-year examination are those institutions that are in excess of \$10 billion in assets and are rated a composite 3 or worse. De novo banks are also ineligible until they are rated 1 or 2 for two consecutive examinations after they have commenced operations. (See SR-91-17.) Also, a bank that undergoes a change in control must be examined by the Federal Reserve within 12 months of the change in control.

## SUPERVISION OF STATE-CHARTERED BANKS

In May 2004, the State–Federal Working Group, an interagency group of state bank commissioners and senior officials from the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC), developed a recommended-practices document designed to reiterate and reaffirm the need for a commonsense approach for collaborating with states in the supervision of state-chartered banking organizations.<sup>2</sup> The recom-

2. The source for the recommended practices is the November 14, 1996, Nationwide State and Federal Supervisory Agreement (the agreement) to enhance the overall state-federal coordinated supervision program for state-chartered banks. The agreement established a set of core principles to promote coordination in the supervision of all interstate banks, with particular emphasis on complex or larger (for example, \$1 billion or more of assets) institutions. (See SR-96-33.) These principles are equally applicable and important when supervisors from federal and state banking agencies are

mended practices highlight the importance of communication and coordination between state and federal banking agencies in the planning and execution of supervisory activities.

When communicating and coordinating with other agencies, examination and supervisory staff should follow the common courtesies and recommended practices identified in the May 2004 document. The recommended practices reinforce the long-standing commitment of federal and state banking supervisors to provide efficient, effective, and seamless oversight of state banks of all sizes, whether those institutions operate in a single state or more than one state. The recommended practices also minimize, to the fullest extent possible, the regulatory burden placed on state-chartered banks—thus further supporting and fostering a seamless supervisory process. (See SR-04-12.)

### Recommended Practices for State Banking Departments, the FDIC, and the Federal Reserve

1. State and federal banking agencies should take steps to ensure that all staff responsible for the supervision and examination of state-chartered banks are familiar with the principles contained in the agreement. State and federal banking agencies should ensure that adherence to the principles in the agreement is communicated as a priority within their respective agencies at all levels of staff—ranging from the field examiners to the officers in charge of supervision and to state bank commissioners.
2. Home-state supervisors should make every effort to communicate and coordinate with host-state supervisors as an important part of supervising multistate banks as specified in the Nationwide Cooperative Agreement executed by the state banking departments and recognized by the federal agencies in the agreement.
3. State and federal banking agencies should consider inviting one another to participate in regional examiner training programs and/or seminars to discuss emerging issues and challenges observed in the banking industry.
4. Federal and state banking departments

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communicating and coordinating the supervision of state-chartered banks operating within a single state.

5. PCPs and examiners-in-charge (EICs) from the state banking department(s) and federal agencies should discuss and prepare supervisory plans at least once during the examination cycle, and more frequently as appropriate for institutions of greater size or complexity or that are troubled. The agencies should discuss and communicate changes to the plan as they may evolve over the examination cycle. The supervisory plans should be comprehensive, including examination plans, off-site monitoring, follow-up or target reviews, supervisory actions, etc., as applicable.
6. The PCPs from the home-state banking department and federal banking agencies should make every effort to share reports that their individual agencies have produced through their off-site monitoring program or through targeted supervisory activities.
7. State and federal banking agencies should notify one another as early as possible if their agency cannot conduct a supervisory event (e.g., examination) that was previously agreed upon—or if the agency intends to provide fewer examiners/resources than originally planned.
8. Meetings with bank management and directors should involve both the appropriate staff from the home-state banking department and from the responsible federal banking agency, whenever possible. If a joint meeting is not possible or appropriate (for example, the bank arranges the meeting with one agency only), the other agency (the home-state banking department or the responsible federal banking agency, as applicable) should be informed of the meeting.
9. The home-state and responsible federal agency should make every effort to issue a joint exam report in the 45-day time frame identified in the agreement. If circumstances prevent adherence to time frames identified in the agreement, the state and federal agencies should coordinate closely and consider benchmarks or timing requirements that may apply to the other agency.
10. All corrective-action plans (for example, memoranda of understanding, cease-and-desist orders) should be jointly discussed, coordinated, and executed to the fullest

extent possible among all examination parties involved. Also, all information on the institution's corrective-action plan and progress made toward implementing the plan should be shared.

11. To ensure that messages to management are consistent to the fullest extent possible, supervisory conclusions or proposed actions should only be communicated to bank management, the bank board of directors, or other bank staff after such matters have been fully vetted within and between the federal banking agency and home-state banking department. The vetting process should, to the fullest extent possible, adhere to the exit meeting and examination report issuance time frames specified in the agreement. All parties should make every effort to expedite the process in order to deliver timely exam findings and efficient regulatory oversight.
12. When differences between the agencies arise on important matters, such as examination conclusions or proposed supervisory action, senior management from the home-state banking department and the appropriate federal banking agency should communicate to try to resolve the differences. In the event that the state and federal banking agency cannot reach agreement on important matters affecting the supervised institution, the respective agencies should coordinate the communication of those differences to the management or board of directors of the supervised institution, including the timing thereof and how the differing views will be presented. (See SR-99-17.)

## EXAMINATION OF INSURED DEPOSITORY INSTITUTIONS PRIOR TO MEMBERSHIP OR MERGER INTO STATE MEMBER BANKS

Premembership examinations of state nonmember banks, national banks, and savings associations seeking to convert to state-membership<sup>2a</sup>

2a. With regard to existing supervised institutions that are seeking to become state member banks, the Federal Reserve and the other agencies of the Federal Financial Institutions Examination Council issued on July 1, 2009, a *Statement on Regulatory Conversions*. This statement, among other things, emphasized that the agencies will only consider applications undertaken for legitimate reasons and will not entertain

status will not be required if the bank or savings association seeking membership meets the criteria for "eligible bank," as defined in section 208.2(e) of Regulation H.<sup>2b</sup> Additionally, examinations of state nonmember banks, national banks, and savings associations seeking to merge into a state member bank will not be required so long as the state member bank, on an existing and pro forma basis, meets the criteria for "eligible bank."

For those insured depository institutions that are not subject to a premembership or premerger examination under this policy statement, any required risk assessments and supervisory strategies should be completed no later than 30 days after the conversion or merger. To the extent issues or concerns arise, targeted or, if warranted, full-scope examinations of the converted or merged institution should be conducted as soon as possible after the conversion or merger. With respect to a state member bank that was formerly a savings association or that acquired a savings association, the risk assessment and supervisory strategy should pay particular attention to activities conducted by any service corporation subsidiary that may not be permissible activities for a state member bank, when such activities have not yet been conformed.<sup>2c</sup>

Premembership or premerger examinations should generally be conducted for an insured depository institution that does not meet the criteria for eligible bank. In the case of safety-and-soundness examinations and consistent with

regulatory conversion applications that undermine the supervisory process. Further, section 612 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) also imposes restrictions on certain charter conversions. Applications that involve state member bank conversions should be reviewed for consistency with both the interagency statement on regulatory conversions and any applicable Dodd-Frank restrictions. (See SR-11-2.)

2b. "Eligible bank" is defined to mean a member bank that (1) is well capitalized under subpart D of Regulation H; (2) has a composite CAMELS rating of 1 or 2; (3) has a CRA rating of Outstanding or Satisfactory; (4) has a rating of 1 or 2 as of its most recent consumer compliance examination; and (5) has no major unresolved supervisory issues outstanding, as determined by the Board or appropriate Federal Reserve Bank in its discretion. In general if significant trust or fiduciary activities are found to be conducted in a less-than-satisfactory manner, an insured depository institution would typically not meet requirement (5).

2c. The Board, in acting on a membership application, is required to consider whether the corporate powers to be exercised are consistent with the purposes of the Federal Reserve Act (12 USC 322). In addition, section 208.3(d)(2) of Regulation H requires a state member bank to obtain the Board's permission prior to changing the scope of powers it exercises. (See SR-11-2.)

a risk-focused approach, these examinations can be targeted, as appropriate, to the identified area (or areas) of weakness. The Reserve Bank may, in its discretion, waive the examination requirement if it is determined that conducting an examination would be (1) inconsistent with a risk-focused approach and/or (2) unlikely to provide information that would assist materially in evaluating the statutory and regulatory factors that the Federal Reserve is required to consider in acting on the membership or merger application.<sup>2d</sup> If an examination is waived, the Reserve Bank should prepare and maintain documentation supporting its decision.

In all circumstances, each Reserve Bank is responsible for adhering to the examination-frequency time frames established by Federal Reserve policy, section 111 of the Federal Deposit Insurance Corporation Act (12 USC 1820(d)(4)) and section 809 of the Gramm-Leach-Bliley Act. When the statutory deadline for an examination of a depository institution seeking membership is approaching or has passed, a Federal Reserve examination of the institution should be conducted as soon as practicable after the institution becomes a state member bank. (See SR-11-2). It also includes additional guidance on pre-membership or pre-merger examinations with respect to CRA performance and compliance, and the fiduciary and transfer agent activities of state chartered banks.)

## OBJECTIVES OF THE SUPERVISORY PROCESS

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

- *Provides flexible and responsive supervision.* The supervisory process is dynamic and forward-looking, so it responds to technological advances, product innovation, and new risk-management systems and techniques, as well as to changes in the condition of an individual financial institution and to market developments.
- *Fosters consistency, coordination, and communication among the appropriate supervisors.* Seamless supervision, which reduces

regulatory burden and duplication, is promoted. The supervisory process uses examiner resources effectively by using the institution's internal and external risk-assessment and -monitoring systems; making appropriate use of joint and alternating examinations; and tailoring supervisory activities to an institution's condition, risk profile, and unique characteristics.

- *Promotes the safety and soundness of financial institutions.* The supervisory process effectively evaluates the safety and soundness of banking institutions, including the assessment of risk-management systems, financial condition, and compliance with laws and regulations.
- *Provides a comprehensive assessment of the institution.* The supervisory process integrates specialty areas (for example, information technology systems, trust, capital markets, and consumer compliance) and functional risk assessments and reviews, in cooperation with interested supervisors, into a comprehensive assessment of the institution.

## RISK-FOCUSED EXAMINATIONS

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

To ensure that institutions have in place the processes necessary to identify, measure, monitor, and control risk exposures, examinations have increasingly emphasized evaluating the appropriateness of these processes, evolving away from a high degree of transaction testing. Under a risk-focused examination approach, the degree of transaction testing should be reduced when internal risk-management processes are determined to be adequate or when risks are minimal. However, when risk-management pro-

<sup>2d</sup>. Since membership in the Federal Reserve System does not confer deposit insurance, CRA does not, by its terms, apply to membership applications.



cesses or internal controls are considered inappropriate, such as by an inadequate segregation of duties or when on-site testing determines processes to be lacking, additional transaction testing must be performed. Testing should be sufficient to fully assess the degree of risk exposure in a particular function or activity. In addition, if an examiner believes that a banking organization's management is being less than candid, has provided false or misleading information, or has omitted material information, then substantial on-site transaction testing should be performed.

## Compliance with Laws and Regulations

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

### *Changes in the General Character of a Bank's Business*

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

State member banks must receive the prior

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

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

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

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

## Branches

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

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

Insured depository institutions that intend to close branches must comply with the requirements detailed in section 42 of the Federal Deposit Insurance Act (the FDI Act) (12 USC 1831r-1). Section 42(e) requires that banks provide 90 days' notice to both customers and, in the case of insured state member banks, the Federal Reserve Board, before the date of the proposed branch closings. The notice must include a detailed statement of the reasons for the decision to close the branch and statistical and other information in support of those stated reasons. A similar notice to customers must be posted in a conspicuous manner on the premises of the branch to be closed, at least 30 days before the proposed closing. There are additional notice, meeting, and consultation requirements for proposed branch closings by interstate banks in low- or moderate-income areas. Finally, the law requires each insured depository insti-

tution to adopt policies for branch closings. (See the revised joint policy statement concerning insured depository institutions' branch-closing notices and policies, effective June 29, 1999,<sup>2e</sup> *Federal Reserve Regulatory Service*, 3-1503.5.) Examiners and supervisors need to be mindful of the section 42 statutory requirements and this joint policy.

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

## Establishing a De Novo Branch

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") modified the federal statute governing de novo interstate branching by state member banks. As a result, as of July 22, 2010, a state member bank is authorized to open its initial branch in a host state<sup>2f</sup> by establishing a de novo branch at any location at which a bank chartered by the host state could establish a branch.<sup>2g</sup>

Just as it must do in establishing any domestic branch, a state member bank seeking to open a

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

2f. "Host state" means a state, other than a bank's home state, in which the bank seeks to establish and maintain a branch. 12 USC 36(g)(3)(C).

2g. 12 USC 36(g)(1)(A), as amended by section 613(a) of the Dodd-Frank Act; 12 USC 321. Initial entry into a host state by way of an interstate bank merger is governed by 12 USC 1831u.



de novo interstate branch must file an application with the Federal Reserve pursuant to the procedures and standards set forth in section 208.6 of the Board's Regulation H.<sup>2h</sup> In addition, applications for de novo interstate branches are subject to state filing requirements and to capital, management, and community reinvestment standards.<sup>2i</sup> See SR-11-3.

### *Prohibition on Branches Being Established Primarily for Deposit Production*

Section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Act) (12 USC 1835a) prohibits any bank from establishing or acquiring a branch or branches outside of its home state primarily for the purpose of deposit production. In 1997, the banking agencies published a joint final rule implementing section 109. (See 62 *Fed. Reg.* 47728, September 10, 1997.) Section 106 of the Gramm-Leach-Bliley Act of 1999 expanded the coverage of section 109 of the Interstate Act to include any branch of a bank controlled by an out-of-state bank holding company. On June 6, 2002, the Board and the other banking agencies published an amendment to their joint final rule (effective October 1, 2002) to conform the uniform rule to section 109. (See 67 *Fed. Reg.* 38844.) The amendment expands the regulatory prohibition against interstate branches being used as deposit-production offices to include any bank or branch of a bank controlled by an out-of-state bank holding company, including a bank consisting only of a main office. (See Regulation H, section 208.7(b)(2).)

### *Minimum Statewide Loan-to-Deposit Ratios*

Section 109 sets forth a process to test compliance with the statutory requirements. First, a bank's statewide loan-to-deposit ratio<sup>2j</sup> is com-

pared with the host-state loan-to-deposit ratio<sup>2k</sup> for banks in a particular state. If the bank's statewide loan-to-deposit ratio is at least one-half of the published host-state loan-to-deposit ratio, then it has complied with section 109. A second step is conducted if a bank's statewide loan-to-deposit ratio is less than one-half of the published ratio for that state or if data are not available at the bank to conduct the first step. The second step involves determining whether the bank is reasonably helping to meet the credit needs of the communities served by its interstate branches. If a bank fails both of these steps, it has violated section 109 and is subject to sanctions.

## RISK-MANAGEMENT PROCESSES AND INTERNAL CONTROLS

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

- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Market risk* is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, such as interest rates, foreign-exchange rates, or equity prices.
- *Liquidity risk* is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk"), or the potential that the institution cannot easily unwind or offset specific exposures without

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

2h. 12 CFR 208.6.

2i. 12 USC 36(g)(1)(A), as amended by section 613(a) of the Dodd-Frank Act; 12 USC 321. Initial entry into a host state by way of an interstate bank merger is governed by 12 USC 1831u.

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

- significantly lowering market prices because of inadequate market depth or market disruptions (referred to as “market liquidity risk”).
- *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
  - *Legal risk* arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a banking organization.
  - *Reputational risk* is the potential that negative publicity regarding an institution’s business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.

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

## Elements of Risk Management

When evaluating the quality of risk management as part of the evaluation of the overall quality of management, examiners should consider findings relating to the following elements of a sound risk-management system:

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

Adequate risk-management programs can vary considerably in sophistication, depending on the size and complexity of the banking organization and the level of risk that it accepts. For smaller institutions engaged solely in traditional banking activities and whose senior managers and directors are actively involved in the details of day-to-day operations, relatively basic risk-management systems may be adequate. However, large, multinational organizations will require far more elaborate and formal risk-management systems to address their broader

and typically more-complex range of financial activities, and to provide senior managers and directors with the information they need to monitor and direct day-to-day activities. In addition to the banking organization’s market and credit risks, risk-management systems should encompass the organization’s trust and fiduciary activities, including investment advisory services, mutual funds, and securities lending.

### *Active Board and Senior Management Oversight*

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

- The board and senior management have identified and have a clear understanding and working knowledge of the types of risks inherent in the institution’s activities, and they make appropriate efforts to remain informed about these risks as financial markets, risk-management practices, and the institution’s activities evolve.
- The board has reviewed and approved appropriate policies to limit risks inherent in the institution’s lending, investing, trading, trust, fiduciary, and other significant activities or products.
- The board and management are sufficiently familiar with and are using adequate record-keeping and reporting systems to measure and monitor the major sources of risk to the organization.
- The board periodically reviews and approves risk-exposure limits to conform with any changes in the institution’s strategies, reviews new products, and reacts to changes in market conditions.
- Management ensures that its lines of business are managed and staffed by personnel whose

knowledge, experience, and expertise is consistent with the nature and scope of the banking organization's activities.

- Management ensures that the depth of staff resources is sufficient to operate and soundly manage the institution's activities, and ensures that employees have the integrity, ethical values, and competence that are consistent with a prudent management philosophy and operating style.
- Management at all levels provides adequate supervision of the day-to-day activities of officers and employees, including management supervision of senior officers or heads of business lines.
- Management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the organization is active.
- Before embarking on new activities or introducing new products, management identifies and reviews all risks associated with the activities or products and ensures that the infrastructure and internal controls necessary to manage the related risks are in place.

### *Adequate Policies, Procedures, and Limits*

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

- The institution's policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its lending, investing, trading, trust, fiduciary, and other significant activities.
- The policies, procedures, and limits are consistent with management's experience level, the institution's stated goals and objectives, and the overall financial strength of the organization.
- Policies clearly delineate accountability and lines of authority across the institution's activities.
- Policies provide for the review of new activities to ensure that the financial institution has the necessary infrastructures to identify, monitor, and control risks associated with an activity before it is initiated.

### *Adequate Risk Monitoring and Management Information Systems*

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

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

### *Adequate Internal Controls*

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

- The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the organization's activities.
- The institution's organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits.
- Reporting lines for the control areas are independent from the business lines, and there is adequate separation of duties throughout the organization—such as duties relating to trading, custodial, and back-office activities.
- Official organizational structures reflect actual operating practices.
- Financial, operational, and regulatory reports are reliable, accurate, and timely, and, when

applicable, exceptions are noted and promptly investigated.

- Adequate procedures exist for ensuring compliance with applicable laws and regulations.
- Internal audit or other control-review practices provide for independence and objectivity.
- Internal controls and information systems are adequately tested and reviewed. The coverage of, procedures for, and findings and responses to audits and review tests are adequately documented. Identified material weaknesses are given appropriate and timely high-level attention, and management's actions to address material weaknesses are objectively verified and reviewed.
- The institution's audit committee or board of directors reviews the effectiveness of internal audits and other control-review activities regularly.

## RISK-FOCUSED SUPERVISION OF COMMUNITY BANKS

### Understanding the Bank

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

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

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

### Reliance on Internal Risk Assessments

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

### Preparation of a Scope Memorandum

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

the bank's condition. Some of the key factors that should be addressed in the scope memorandum are described below.

### *Preliminary Risk Assessment*

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

### *Summary of Pre-Examination Meeting*

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

### *Summary of Audit and Internal Control Environment*

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

### *Summary of Examination Procedures*

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

each module to be emphasized during the examination process. In addition, any supplemental modules used should be discussed.

### *Summary of Loan Review*

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

### *Job Staffing*

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

## Examination Modules

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

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

for those decision factors that present the greatest degree of risk for the bank. However, if the risks are properly managed, the examiner can conclude the review.

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

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

## RISK-FOCUSED SUPERVISION OF LARGE COMPLEX INSTITUTIONS

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

The examination approaches for both large complex institutions and community banks are risk-focused processes that rely on an understanding of the institution, the performance of risk assessments, the development of a supervisory plan, and examination procedures tailored to the risk profile. However, the two approaches

are implemented differently: The process for complex institutions relies more heavily on a central point of contact and detailed risk assessments and supervisory plans before the on-site examination or inspection. In comparison, for small or noncomplex institutions and community banks, risk assessments and examination activities may be adequately described in the scope memorandum.

## Key Elements

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

- *Designation of a central point of contact.* Large institutions typically have operations in several jurisdictions, multiple charters, and diverse product lines. Consequently, the supervisory program requires that a "central point of contact" be designated for each institution to facilitate coordination and communication among the numerous regulators and specialty areas.
- *Review of functional activities.* Large institutions are generally structured along business lines or functions, and some activities are managed on a centralized basis. As a result, a single type of risk may cross several legal entities. Therefore, the supervisory program incorporates assessments along functional lines to evaluate risk exposure and its impact on safety and soundness. These functional reviews will be integrated into the risk assessments for specific legal entities and used to support the supervisory ratings for individual legal entities.<sup>3</sup>
- *Focus on risk-management processes.* Large institutions generally have highly developed risk-management systems, such as internal audit, loan review, and compliance. The supervisory program emphasizes each institution's responsibility to be the principal source for detecting and deterring abusive and unsound practices through adequate internal controls and operating procedures. The pro-

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



gram incorporates an approach that focuses on and evaluates the institution's risk-management systems, yet retains transaction testing and supervisory rating systems, such as the CAMELS, bank holding company RFI/C(D), and ROCA rating systems. This diagnostic perspective is more dynamic and forward looking because it provides insight into how effectively an institution is managing its operations and how well it is positioned to meet future business challenges.

- *Tailoring of supervisory activities.* Large institutions are unique, but all possess the ability to quickly change their risk profiles. To deliver effective supervision, the supervisory program incorporates an approach that tailors supervisory activities to the risk profile of an institution. By concentrating on an institution's major risk areas, examiners can achieve a more relevant and penetrating understanding of the institution's condition.
- *Emphasis on ongoing supervision.* Large institutions face a rapidly changing environment. Therefore, the supervisory program emphasizes ongoing supervision through increased planning and off-site monitoring. Ongoing supervision allows for timely adjustments to the supervisory strategy as conditions change within the institution and economy.

## Covered Institutions

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

tions with consolidated assets less than \$1 billion.

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

## Coordination of Supervisory Activities

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

The RRB is accountable for all aspects of the supervision of a fully consolidated banking organization, which includes the supervision of all the institution's subsidiaries and affiliates (domestic, foreign, and Edge corporations) for which the Federal Reserve has supervisory oversight responsibility. The RRB is generally expected to work with LRBs in conducting examinations and other supervisory activities, particularly where significant banking operations are conducted in a local District. Thus, for state member banks, the LRB has an important role in the supervision of that subsidiary. However, the RRB retains authority and accountabil-

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

ity for the results of all examinations and reviews that an LRB may perform on its behalf. See SR-05-27/CA-05-11.

### *Responsible Reserve Bank*

In general, the RRB for a banking institution has been the Reserve Bank in the District where the banking operations of the organization are principally conducted. For domestic banking institutions, the RRB typically will be the Reserve Bank District where the head office of the top-tier institution is located and where its overall strategic direction is established and overseen. For foreign banking institutions, the RRB typically will be the Reserve Bank District where the Federal Reserve has the most direct involvement in the day-to-day supervision of the U.S. banking operations of the institution.

When necessary, the Board's Division of Banking Supervision and Regulation (BS&R), in consultation with the Division of Consumer and Community Affairs (C&CA), may designate an RRB when the general principles set forth above could impede the ability of the Federal Reserve to perform its functions under law, do not result in an efficient allocation of supervisory resources, or are otherwise not appropriate.

### *Duties of RRBs*

The RRB develops the consolidated risk assessment and supervisory plan and ensures that the scope and timing of planned activities conducted by participating Districts and agencies pursuant to the plan are appropriate, given the consolidated risk assessment. The RRB designates the central point of contact or lead examiner and ensures that all safety-and-soundness, information technology, trust, consumer compliance, Community Reinvestment Act (CRA), and other specialty examinations, inspections, and visitations are conducted and appropriately coordinated within the System and with other regulators. In addition, the RRB manages all formal communications with the foreign and domestic supervised entity, including the the communication of supervisory assessments, ratings, and remedial actions.<sup>5</sup>

5. See SR-97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions," and SR-96-33, "State/Federal Protocol and Nationwide Supervisory Agreement."

### *Sharing of RRB Duties*

To take advantage of opportunities to enhance supervisory effectiveness or efficiency, an RRB is encouraged to arrange for the LRB to undertake on its behalf certain examinations or other supervisory activities. For example, an LRB may have relationships with local representatives of the institution or local supervisors; leveraging these relationships may facilitate communication and reduce costs. Additionally, LRBs may provide specialty examination resources—in the case of CRA examinations, LRB staff often provide valuable insights into local communities and lending institutions that should be factored into the CRA assessment. When other Reserve Bank Districts conduct examinations and other supervisory activities for the RRB, substantial reliance should be placed on the conclusions and ratings recommended by the participating Reserve Bank(s).

The RRB retains authority and accountability for the results of all examinations and reviews performed on its behalf and, therefore, must work closely with LRB examination teams to ensure that examination scopes and conclusions are consistent with the supervisory approach and message applied across the consolidated organization. If an LRB identifies major issues in the course of directly conducting supervisory activities on behalf of an RRB, those issues should be brought to the attention of the RRB in a timely manner.

If an RRB arranges for an LRB to conduct supervisory activities on its behalf, the LRB is responsible for the costs of performing the activities. If the LRB is unable to fulfill the request from the RRB to perform the specified activities, the RRB should seek System assistance, if needed, by contacting Board staff or using other established procedures for coordinating resources.

In general, LRBs are responsible for the direct supervision of state member banks located in their district. LRBs and host states will not routinely examine branches of state member banks or issue separate ratings and reports of examination. Similar to the relationship between the RRBs and LRBs, home-state supervisors<sup>6</sup>

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



will coordinate the activities of all state banking departments and will be the state's principal source of contact with federal banking agencies and with the bank itself. Also, host states will not unilaterally examine branches of interstate banks. Close coordination among the Reserve Banks and other appropriate regulators for each organization is critical to ensure a consistent, risk-focused approach to supervision.

## Central Point of Contact and Supervisory Teams

A central point of contact is critical to fulfilling the objectives of seamless, risk-focused supervision. The RRB should designate a central point of contact for each large complex institution it supervises. Generally, all activities and duties of other areas within the Federal Reserve, as well as those conducted with other supervisors, should be coordinated through this contact. The central point of contact should—

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

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

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

## Sharing of Information

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

## Confidentiality Provisions in Agreements that Prevent or Restrict Notification to the Federal Reserve

The Federal Reserve has stated and clarified its expectations regarding confidentiality provisions that are contained in agreements between a banking organization and its counterparties (for example, mutual funds, hedge funds, and other trading counterparties) or other third parties. It is contrary to Federal Reserve's regulations and policy for agreements to contain confidentiality provisions that (1) restrict the banking organization from providing information to Federal Reserve supervisory staff;<sup>6a</sup> (2) require or permit, without the prior approval of the Federal Reserve, the banking organization to disclose to a counterparty that any information will be or was provided to Federal Reserve supervisory

<sup>6a</sup> Supervisory staff include individuals that are on and/or off site.

staff; or (3) require or permit, without the prior approval of the Federal Reserve, the banking organization to inform a counterparty of a current or upcoming Federal Reserve examination or any nonpublic Federal Reserve supervisory initiative or action. Banking organizations that have entered, or enter, into agreements containing such confidentiality provisions are subject to legal risk. (See SR-07-19 and SR-97-17.) For information on the restrictions pertaining to the very limited disclosure of confidential supervisory ratings and other nonpublic supervisory information, see SR-05-4, SR-96-26, and SR-88-37. See also section 5020.1.

## Functional Approach and Targeted Examinations

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

The functional approach focuses principally on the key business activities (for example, lending, Treasury, retail banking) rather than on reviewing the legal entity and its balance sheet. This approach does not mean that the responsibility for a legal-entity assessment is ignored, nor should the Federal Reserve perform examinations of institutions that other regulators are primarily responsible for supervising.<sup>7</sup> Rather, Federal Reserve examiners should integrate the findings of a functional review into the legal-entity assessment and coordinate closely with the primary regulator to gather sufficient information to form an assessment of the consolidated organization. Nonetheless, in some cases, effective supervision of the consolidated organization may require Federal Reserve examiners to perform process reviews and possibly transaction testing at all levels of the organization.

Functional risk-focused supervision is to be achieved by—

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

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

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

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

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

## Process and Products

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

Table 1—Steps and Products

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

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

## Understanding the Institution

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

supervisory role in relation to an institution and its affiliates is essential.

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

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

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

### *Preparation of the Institutional Overview*

The institutional overview should contain a concise executive summary that demonstrates an understanding of the institution's present condition and its current and prospective risk profiles, as well as highlights key issues and past

supervisory findings. General types of information that may be valuable to present in the overview include—

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

### *Assessing the Institution's Risks*

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

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

### *Assessment of the Overall Risk Environment*

The starting point in the risk-assessment process is an evaluation of the institution's risk tolerance

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

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

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

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

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

trading systems. Accordingly, the institution's risk assessment must consider the adequacy of its information technology systems.

### *Preparation of the Risk Matrix*

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

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

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

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

loss to the organization, the loss could be absorbed by the organization in the normal course of business.

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

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

### *Assessing Adequacy of Risk Management*

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

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

- *Strong risk management* indicates that management effectively identifies and controls all major types of risk posed by the relevant activity or function. The board and management participate in managing risk and ensure that appropriate policies and limits exist, which the board understands, reviews, and approves. Policies and limits are supported by risk-monitoring procedures, reports, and management information systems that provide the necessary information and analysis to make timely and appropriate responses to changing conditions. Internal controls and audit procedures are appropriate to the size and activities of the institution. There are few exceptions to established policies and procedures, and none of these exceptions would likely lead to a significant loss to the organization.

- *Acceptable risk management* indicates that the institution's risk-management systems, although largely effective, may be lacking to some modest degree. It reflects an ability to cope successfully with existing and foreseeable exposure that may arise in carrying out the institution's business plan. While the institution may have some minor risk-management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk-monitoring procedures, reports, and management information systems are considered effective in maintaining a safe and sound institution. Risks are generally being controlled in a manner that does not require more than normal supervisory attention.

- *Weak risk management* indicates risk-management systems that are lacking in important ways and, therefore, are a cause for more than normal supervisory attention. The internal control system may be lacking in important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The deficiencies associated in these systems could have adverse effects on the safety and soundness of the institution or could lead to a material misstatement of its financial statements if corrective actions are not taken.

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

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

- A *high composite risk* generally would be assigned to an activity in which the risk-

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

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

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

## Preparation of the Risk Assessment

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

servicing as a platform for developing the supervisory plan.

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

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

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

## Planning and Scheduling Supervisory Activities

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



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

### *Preparation of the Supervisory Plan*

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

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

- prioritizing supervisory resources on areas of higher risk;
- pooling examiner resources to reduce the regulatory burden on institutions as well as examination redundancies;
- maximizing the use of examiners who are located where the activity is being conducted;

- coordinating examinations of different disciplines;
- determining compliance with, or the potential for, supervisory action;
- balancing mandated requirements with the objectives of the plan;
- providing general logistical information (for example, a timetable of supervisory activities, the participants, and expected resource requirements); and
- assessing the extent to which internal and external audit, internal loan review, compliance, and other risk-management systems will be tested and relied upon.

Generally, the planning horizon to be covered is 18 months for domestic institutions.<sup>8</sup> The overall supervisory objectives and basic framework need to be outlined by midyear to facilitate preliminary discussions with other supervisors and to coincide with planning for the Federal Reserve's annual scheduling conferences. The plan should be finalized by the end of the year, for execution in the following year.

### *Preparation of the Examination Program*

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

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

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



- an identification of the agencies conducting and participating in the supervisory activity (when there are joint supervisors, indicate the lead agency and the agency responsible for a particular activity) and resources committed by all participants to the area(s) under review
- the planned product for communicating findings (indicate whether it will be a formal report or supervisory memorandum)
- the need for special examiner skills and the extent of participation of individuals from specialty functions
- a statement of the objectives;
- an overview of the activities and risks to be evaluated;
- the level of reliance on internal risk-management systems and internal or external audit findings;
- a description of the procedures that are to be performed, indicating any sampling process to be used and the level of transaction testing, when appropriate;
- identification of the procedures that are expected to be performed off-site; and
- a description of how the findings of targeted reviews, if any, will be used on the current examination.

## Defining Examination Activities

### *Scope Memorandum*

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

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

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

### *Entry Letter*

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

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

## Examination Procedures

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

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

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

- retail banking activities
- payments system risk

## Reporting the Findings

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

## Minimum Timing Standards for Examination Report Completion

Examination reports issued by the Federal Reserve must be completed and filed within a maximum of 60 calendar days, commencing with the day following the examiner's exit meeting. This standard applies to reports for all banks, regardless of the complexity of the organization. Additionally, for institutions with a CAMELS composite rating of 3, 4, or 5, Reserve Banks are encouraged to adopt an internal target of 45 calendar days for processing and filing reports. In cases where reports are issued jointly with other agencies, this standard may be extended at the discretion of senior management at the Reserve Bank. (See SR-93-4.)

# Internal Control and Audit Function, Oversight, and Outsourcing

Effective date October 2008

## Section 1010.1

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

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

In summary, internal control is a process designed to provide reasonable assurance that the institution will achieve the following objectives: efficient and effective operations, including safeguarding of assets; reliable financial reporting; and compliance with applicable laws and regulations. Internal control consists of five components that are a part of the management

process: control environment, risk assessment, control activities, information and communication, and monitoring activities. The effective functioning of these components, which is brought about by an institution's board of directors, management, and other personnel, is essential to achieving the internal control objectives. This description of internal control is consistent with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) report *Internal Control—Integrated Framework*. In addition, under the COSO framework, financial reporting is defined in terms of published financial statements, which, for these purposes, encompass financial statements prepared in accordance with generally accepted accounting principles and regulatory reports (such as the Reports of Condition and Income). Institutions are encouraged to evaluate their internal control against the COSO framework.

### AUDIT COMMITTEE OVERSIGHT

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

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

The role of the independent audit committee is growing in importance. The audit committee's duties may include (1) overseeing the internal audit function; (2) approving or recommending the appointment of external auditors and the scope of external audits and other services; (3) providing the opportunity for auditors to meet and discuss findings apart from management; (4) reviewing with management and external auditors the year-end financial statements; and (5) meeting with regulatory authorities.

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

## Public Company Accounting Oversight Board

The Sarbanes-Oxley Act of 2002 (the act) became law on July 30, 2002 (Pub. L. No. 107-204). The act addresses weaknesses in corporate governance and the accounting and auditing professions and includes provisions addressing audits, financial reporting and disclosure, conflicts of interest, and corporate governance at publicly owned companies. The act, among other things, requires public companies to have an audit committee made entirely of independent directors. Publicly owned banking organizations that are listed on the New York Stock Exchange (NYSE) and Nasdaq must also comply with those exchanges' listing requirements, which include audit committee requirements.

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

In May 2003, the Federal Reserve, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision announced that they did not expect to take actions to apply the corporate-governance and other requirements of the Sarbanes-Oxley Act generally to nonpublic banking organizations that are not otherwise subject to them.<sup>2</sup> (See SR-03-08.) Nonpublic banking organizations are encouraged to periodically review their policies and procedures relating to corporate-governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance

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

and remain appropriate in light of the organization's size, operations, and resources. Furthermore, a banking organization's policies and procedures for corporate governance, internal controls, and auditing will be assessed during the supervisory process, and supervisory action may be taken if there are deficiencies or weaknesses in these areas that are inconsistent with sound corporate-governance practices or safety-and-soundness considerations.

## DISCIPLINARY ACTIONS AGAINST ACCOUNTANTS AND ACCOUNTING FIRMS PERFORMING CERTAIN AUDIT SERVICES

Section 36 of the Federal Deposit Insurance Act (the FDI Act) authorizes the federal bank and thrift regulatory agencies (the agencies)<sup>3</sup> to take disciplinary actions against independent public accountants and accounting firms that perform audit services covered by the act's provisions. Section 36, as implemented by part 363 of the FDIC's rules (12 CFR 363), requires that each federally insured depository institution with total assets of \$500 million or more obtain an audit of its financial statements and a management report. Institutions with assets of \$1 billion or more must provide an attestation on management's assertions concerning internal controls over financial reporting that is performed by an independent public accountant (the accountant). The respective insured depository institution must include the accountant's audit and attestation reports in its annual report, as required. See the section on "Legal Requirements Affecting Banks and the Audit Function."

The agencies amended their rules, pursuant to section 36, that set forth the practices and procedures to implement their authority to remove, suspend, or debar, for good cause,<sup>3a</sup> an accountant or firm from performing audit and attesta-

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3. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision. The Board approved its rules on August 6, 2003 (press release of August 8, 2003). The rules became effective October 1, 2003.

3a. The rules provide that certain violations of law, negligent conduct, reckless violations of professional standards, or lack of qualifications to perform auditing services may be considered good cause.

tion services for insured depository institutions with assets of \$500 million or more.<sup>3b</sup> Immediate suspensions are permitted in limited circumstances. Also, an accountant or accounting firm is prohibited from performing audit services for the covered institution if an authorized agency has taken such a disciplinary action against the accountant or firm, or if the SEC or the PCAOB has taken certain disciplinary action against the accountant or firm.

The amended rules reflect the agencies' increasing concern about the quality of audits and internal controls for financial reporting at insured depository institutions. The rules emphasize the importance of maintaining high quality in the audits of federally insured depository institutions' financial position and in the attestations of management assessments.

## OBJECTIVES OF INTERNAL CONTROL

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

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

*Competent performance.* For internal control to be effective, the required procedures must be performed by competent persons. Evaluation of competence undoubtedly requires some degree

of subjective judgment because attributes such as intelligence, knowledge, and attitude are relevant. Thus, the examiner should be alert for indications that employees have failed so substantially to perform their duties that a serious question is raised concerning their abilities.

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

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

## PROCEDURES FOR COMPLETING ICQs

The implementation of selected ICQs and the evaluation of internal audit activities provide a basis for determining the adequacy of the bank's control environment. To reach conclusions required by the questionnaires, the examiner

3b. See the Federal Reserve's rules on disciplinary actions against public accountants and accounting firms at 12 CFR 263.94 and 12 CFR 263, subpart J.



assigned to review a given internal control routine or area of bank operations should use any source of information necessary to ensure a full understanding of the prescribed system, including any potential weaknesses. Only when the examiner completely understands the bank's system can an assessment and evaluation be made of the effects of internal controls on the examination.

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

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

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

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

In obtaining and substantiating the answers to the questions in the ICQ, the examiner should

develop a plan to obtain the necessary information efficiently. Such a plan would normally avoid a direct question-and-answer session with bank officers. A suggested approach to completion of the ICQ is to—

- become familiar with the ICQ,
- review related internal audit procedures, reports, and responses,
- review any written documentation of a bank's system of controls,
- find out what the department does and what the functions of personnel within the department are through conversations with appropriate individuals, and
- answer as many individual questions as possible from information gained in the preceding steps and fill in the remaining questions by direct inquiry.

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

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

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

error to be concealed. By directing attention to such situations, an examiner will also consider situations that may permit unintentional errors to remain undetected.

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

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

The ICQs were designed so that answers could be substantiated by (1) inquiry to bank personnel, (2) observation, or (3) testing. However, certain questions are marked with an

asterisk to indicate that they require substantiation through observation or testing. Those questions are deemed so critical that substantiation by inquiry is not sufficient. For those questions substantiated through testing, the nature and extent of the test performed should be indicated adjacent to the applicable step in the ICQ.

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

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

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

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

## Applying the ICQ to Different Situations

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

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

## LEGAL REQUIREMENTS AFFECTING BANKS AND THE AUDIT FUNCTION

The Federal Deposit Insurance Corporation Improvement Act of 1991 amended section 36 of the FDI Act (12 USC 1831m). Since then, the FDIC has made various revisions to its rules at Part 363 (12 CFR 363) and guidelines. When specific reports are required to be submitted to the FDIC to comply with the provisions of compliance with Part 363, the institution must also submit the report to the appropriate federal banking agency and any appropriate state supervisor.

For the purposes of determining the applicability of this rule, an institution should use total assets as reported on its most recent Report of Condition (the Call Report), the date that coincides with the end of the preceding fiscal year. If the fiscal year ends on a date other than the end

of a calendar quarter, the institution is to use the Call Report for the quarter end immediately preceding the end of the fiscal year.

## Institutions with \$500 Million or More but Less Than \$1 Billion in Total Assets

The regulations require these institutions to file an annual report with the FDIC that must include the following:

- Audited comparative annual financial statements;
- The independent public accountant's report on the audited financial statements;
- A management report (comprising its statements and assessments) that is signed by the chief executive officer and chief accounting or chief financial officer. The report should include:
  - A statement of management's responsibilities for:
    - preparing the annual financial statements;
    - establishing and maintaining an adequate internal control structure over financial reporting;
    - complying with the laws and regulations relating to safety and soundness that are designated by the FDIC and the appropriate federal banking agency; and
  - An assessment by management of the institution's compliance with the designated laws and regulations during the fiscal year.

If the institution is a public company or a subsidiary of a public company that would be subject to the provisions of section 404 of the Sarbanes-Oxley Act (Section 404), it must comply with the requirement to file other reports issued by the independent accountant as set forth in section 363.4(c) (12 CFR 363.4(c)). The institutions must provide a copy of the independent accountant's report to the FDIC on the audit of internal control over financial reporting that is required by section 404 with the FDIC within 15 days after receipt. The institutions also are encouraged to submit a copy of management's section 404 report on internal control over financial reporting together with the independent public accountant's internal control report.



## Institutions with \$1 Billion or More in Total Assets

Section 36 of the FDI Act and Part 363 of the FDIC's regulations required insured depository institutions with a least \$1 billion in total assets to file an annual report that must include the following:

- Audited comparative annual financial statements;
- The independent public accountant's report on the audited financial statements;
- A management report that contains:
  - A statement of management's responsibilities for:
    - Preparing the annual financial statements;
    - Establishing and maintaining an adequate internal control structure over financial reporting;
    - Complying with the laws and regulations relating to safety and soundness that are designated by the FDIC and the appropriate federal banking agency; and
  - Assessments by management of:
    - the effectiveness of the institution's internal control structure and procedures over financial reporting as of the end of the fiscal year (12 USC 1831m(b)(2)(B)(i); and
    - the institution's compliance with safety and soundness laws and regulations during the year (12 USC 1831n(b)(2)(B)(ii)); and
- The independent public accountant's attestation report—the independent public accountant is to examine, attest to, and report separately in an attestation report, on the assertions by management's concerning the institution's internal control structure and procedures for financial reporting (12 USC 1831m(c)). The attestation is to be made in accordance with generally accepted standards for attestation engagements.

## Other Requirements—Institutions with \$500 Million or More in Total Assets

Financial reporting encompasses, for the purposes of Part 363, both financial statements prepared in accordance with generally accepted accounting principles and those prepared for

regulatory reporting purposes. Each institution is to have an independent public accountant perform an audit who reports on the institution's annual financial statements in accordance with generally accepted auditing standards and section 37 of the FDI Act (12 USC 1831n). The scope of the audit engagement must be sufficient to permit the accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles. The audit is to be performed using procedures that will objectively determine the accuracy of management's assertions on compliance with safety-and-soundness laws and regulations (12 USC 1831m(b)(2)(A)(iii)),

Each institution must file with the FDIC two copies of the annual report within 90 days after the end of its fiscal year. Notwithstanding the 90-day filing period, each institution must file a copy of each audit and attestation report issued by its independent accountant within 15 days of their receipt.

In addition, each institution is required to file a copy of any management letter, qualification, or any other report issued by its independent public accountant with the FDIC within 15 days of receipt of such letter or report. See section 363.4(c) (12 CFR 363.4(c)).

Each institution is required to establish an audit committee of its board of directors. The duties of the audit committee include reviewing with management and the independent public accountant the basis for, and the results of, the annual independent audit reports and the institution's respective reporting requirements. Each institution with total assets of \$1 billion or more, as of the beginning of the fiscal year, is required to have an audit committee, the members of which must be outside directors who are independent of the institution's management. Institutions with total assets of \$500 million, but less than \$1 billion or more, as of the beginning of the fiscal year, must have an audit committee, the members of which are outside directors, the majority of whom must be independent of the institution's management.

For insured institutions having total assets of more than \$3 billion, the audit committee must (1) have members with banking or related financial management expertise, (2) have access to outside legal counsel, and (3) not include any large customers of the institution. The audit committee also may be required to satisfy other audit committee membership criteria (12 USC

831m (g)(1)(c) and section 363.5(b) (12 CFR 363.5(b)).

Any covered institution with a composite CAMELS rating of 1 or 2 may file the two above-mentioned reports through its parent holding company on a consolidated basis. The Guidelines and Interpretations (appendix A to Part 363) provide that one of the duties of a covered institution's audit committee should include oversight of the internal audit function and its operations. (See SR-96-4.)

## INTERAGENCY POLICY STATEMENT ON THE INTERNAL AUDIT FUNCTION AND ITS OUTSOURCING

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

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

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

VICES" (hereafter collectively referred to as outsourcing). Typical outsourcing arrangements are more fully described below.

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

### Internal Audit Function (Part I)

#### *Board and Senior Management Responsibilities*

The board of directors and senior management

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

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

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

Directors should be confident that the internal

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

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

4. As noted above, under section 36 of the FDI Act, as implemented by part 363 of the FDIC's regulations (12 CFR 363), FDIC-insured depository institutions with total assets of \$500 million or more must submit an annual management report signed by the chief executive officer (CEO) and chief accounting or chief financial officer. This report must contain (1) a statement of management's responsibilities for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with designated laws and regulations relating to safety and soundness, including management's assessment of the institution's compliance with those laws and regulations, and (2) for an institution with total assets of \$1 billion or more at the beginning of the institution's most recent fiscal year, an assessment by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year. (See 12 CFR 363.2(b) and 70 *Fed. Reg.* 71,232, Nov. 28, 2005.)

5. Depository institutions subject to section 36 of the FDI Act and part 363 of the FDIC's regulations must maintain independent audit committees (i.e., consisting of directors who are not members of management). Consistent with the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations, the agencies also encourage the board of directors of each depository institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors. Where the term *audit committee* is used in this policy statement, the board of directors may fulfill the audit committee responsibilities if the institution is not subject to an audit committee requirement. See *Fed. Reg.*, September 28, 1999 (64 FR 52,319).

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

*ship with the Audit Committee*, which provides more guidance on the roles and relationships between the audit committee and the internal audit manager.

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

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

monitoring functions.

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

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

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

Ideally, the internal audit function's only role should be to independently and objectively evaluate and report on the effectiveness of an institution's risk-management, control, and governance processes. Internal auditors increasingly have taken a consulting role within institutions on new products and services and on mergers, acquisitions, and other corporate reorganiza-

tions. This role typically includes helping design controls and participating in the implementation of changes to the institution's control activities. The audit committee, in its oversight of the internal audit staff, should ensure that the function's consulting activities do not interfere or conflict with the objectivity it should have with respect to monitoring the institution's system of internal control. In order to maintain its inde-

pendence, the internal audit function should not assume a business-line management role over control activities, such as approving or implementing operating policies or procedures, including those it has helped design in connection with its consulting activities. The agencies encourage internal auditors to follow the IIA's standards, including guidance related to the internal audit function acting in an advisory capacity.

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

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

*Communication.* To properly carry out their responsibility for internal control, directors and senior management should foster forthright com-

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

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

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

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

### *Small Financial Institution's Internal Audit Function*

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

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

and review of internal controls and information systems.

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

## Internal Audit Outsourcing Arrangements (Part II)

### *Examples of Internal Audit Outsourcing Arrangements*

An outsourcing arrangement is a contract between an institution and an outsourcing vendor to provide internal audit services. Outsourcing arrangements take many forms and are used by institutions of all sizes. Some institutions consider entering into these arrangements to enhance the quality of their control environment by obtaining the services of a vendor with the knowledge and skills to critically assess, and recommend improvements to, their internal control systems. The internal audit services under contract can be limited to helping internal audit staff in an assignment for which they lack expertise. Such an arrangement is typically under the control of the institution's manager of inter-

nal audit, and the outsourcing vendor reports to him or her. Institutions often use outsourcing vendors for audits of areas requiring more technical expertise, such as electronic data processing and capital-markets activities. Such uses are often referred to as "internal audit assistance" or "audit co-sourcing."

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

### *Additional Considerations for Internal Audit Outsourcing Arrangements*

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

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

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

institution and the vendor typically include provisions that—

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

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

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

management or an employee and, if applicable, will comply with AICPA, U.S. Securities and Exchange Commission (SEC), PCAOB, or regulatory independence guidance.

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

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

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



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

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

### Independence of the Independent Public Accountant (Part III)

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

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

#### *Applicability of the SEC’s Auditor Independence Requirements*

*Institutions that are public companies.* To strengthen auditor independence, Congress passed the Sarbanes-Oxley Act of 2002 (the act). Title II of the act applies to any public company—that is, any company that has a class of securities registered with the SEC or the appropriate federal banking agency under section 12 of the Securities Exchange Act of 1934 or that is required to file reports with the SEC

under section 15(d) of that act.<sup>11</sup> The act prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit outsourcing services to the company.<sup>12</sup> In addition, if a public company’s external auditor will be providing auditing services and permissible nonaudit services, such as tax services, the company’s audit committee must preapprove each of these services.

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

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

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

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

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

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

*Institutions not subject to section 36 of the FDI Act that are neither public companies nor subsidiaries of public companies.* The agencies have long encouraged each institution not subject to section 36 of the FDI Act that is neither a public company nor a subsidiary of a public company<sup>16</sup> to have its financial statements

audited by an independent public accountant.<sup>17</sup> The agencies also encourage each such institution to follow the internal audit outsourcing prohibition in the Sarbanes-Oxley Act, as discussed above for institutions that are public companies.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The AICPA has issued guidance indicating that a member CPA would be deemed not independent of his or her client when the CPA acts or appears to act in a capacity equivalent to a member of the client's management or as a client employee. The AICPA's guidance includes illustrations of activities that would be considered to compromise a CPA's independence. Among these are activities that involve the CPA authorizing, executing, or consummating trans-

actions or otherwise exercising authority on behalf of the client. For additional details, refer to Interpretation 101-3, Performance of Other Services, and Interpretation 101-13, Extended Audit Services, in the AICPA's *Code of Professional Conduct*.

## Examination Guidance (Part IV)

### *Review of the Internal Audit Function and Outsourcing Arrangements*

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

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

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

performance of these services on the auditor's independence.

19. 15 USC 78j-1.

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

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

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

*Examination concerns about the adequacy of the internal audit function.* If the examiner concludes that the institution's internal audit

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

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

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

If the agency staff concurs that the independence of the external auditor or other vendor

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

## INDEPENDENCE OF INTERNAL AUDITORS

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

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

## Competence of Internal Auditors

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

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

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

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

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

and financial aspects of the organization.

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

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

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

## IMPLEMENTATION OF THE INTERNAL AUDIT FUNCTION

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

### Risk Assessment

In setting the annual audit plan, a risk assessment should be made that documents the internal audit function's understanding of the institution's various business activities and their inherent risks. In addition, the assessment also evaluates control risk, or the potential that deficiencies in the system of internal control

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

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

### Audit Plan

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

A formal, annual audit plan should be developed based on internal audit's risk assessment. The audit plan should include all auditable areas and set priorities based on the rating determined by the risk assessment. The schedule of planned audits should be approved by the board or its audit committee, as should any subsequent changes to the plan. Many organiza-

tions develop an audit plan jointly with the external auditors. In this case, the audit plan should clearly indicate what work is being performed by internal and external auditors and what aspects of internal audit work the external auditors are relying on.

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

## Audit Manual

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

## Performance of Individual Audits

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

### *Audit Program and Related Workpapers*

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

### *Audit Reports*

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

## EXAMINER REVIEW OF INTERNAL AUDIT

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

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

The examiner should indicate in the report of examination any significant deficiencies concern-

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

## Program Adequacy and Effectiveness

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

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

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

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

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

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

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

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

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

## EXTERNAL AUDITS

The Federal Reserve requires bank holding companies with total consolidated assets of \$500 million or more to have annual independent audits. Generally, banks must have external audits for the first three years after obtaining FDIC insurance (an FDIC requirement) and upon becoming a newly chartered national bank (an OCC



requirement). The SEC also has a longstanding audit requirement for all public companies, which applies to bank holding companies that are SEC registrants and to state member banks that are subject to SEC reporting requirements pursuant to the Federal Reserve's Regulation H.

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

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

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

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

The examiner is interested in the work per-

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

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

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

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

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

### Introduction

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

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

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

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

To help ensure accurate and reliable financial reporting, the agencies recommend that the board of directors of each institution establish and maintain an external auditing program. An external auditing program should be an important component of an institution's overall risk-management process. For example, an external auditing program complements the internal auditing function of an institution by providing management and the board of directors with an independent and objective view of the reliability of the institution's financial statements and the adequacy of its financial-reporting internal controls. Additionally, an effective external auditing program contributes to the efficiency of the agencies' risk-focused examination process. By

considering the significant risk areas of an institution, an effective external auditing program may reduce the examination time the agencies spend in such areas. Moreover, it can improve the safety and soundness of an institution substantially and lessen the risk the institution poses to the insurance funds administered by the Federal Deposit Insurance Corporation (FDIC).

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

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

## Overview of External Auditing Programs

### *Responsibilities of the Board of Directors*

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

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

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

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

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

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

### *Audit Committee*

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

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

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

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

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

## External Auditing Programs

### *Basic Attributes*

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

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

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

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

### *Types of External Auditing Programs*

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

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

A financial statement audit provides assurance about the fair presentation of an institution's financial statements. In addition, an audit may provide recommendations for management in carrying out its control responsibilities. For example, an audit may provide management with guidance on establishing or improving accounting and operating policies and recom-

mendations on internal control (including internal auditing programs) necessary to ensure the fair presentation of the financial statements.

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

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

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

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

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

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

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

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

When choosing this type of external auditing program, the board or audit committee is responsible for determining whether these procedures meet the external auditing needs of the institution, considering its size and the nature, scope, and complexity of its business activities. For example, if an institution's external auditing program consists solely of confirmations of deposits and loans, the board or committee should consider expanding the scope of the auditing work performed to include additional procedures to test the institution's high-risk areas. Moreover, a financial statement audit, an

examination of the effectiveness of the internal control structure over financial reporting, and a balance-sheet audit may be accepted in some states and for national banks in lieu of agreed-upon procedures/state-required examinations.

### *Other Considerations*

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

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

## Special Situations

### *Holding Company Subsidiaries*

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

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

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

### *Newly Insured Institutions*

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

### *Institutions Presenting Supervisory Concerns*

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

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

- inadequate internal control, including the internal auditing program;
- a board of directors generally uninformed about internal control;
- evidence of insider abuse;
- known or suspected defalcations;
- known or suspected criminal activity;
- probable director liability for losses;

- the need for direct verification of loans or deposits;
- questionable transactions with affiliates; or
- the need for improvements in the external auditing program.

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

## Examiner Guidance

### *Review of the External Auditing Program*

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

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

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

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

independence regarding relationships with the institution under relevant professional standards;

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

### *Access to Reports*

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

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

Institutions should provide reports<sup>30</sup> issued by the independent public accountant or other auditor pertaining to the external auditing program, including any management letters, to the agencies and any state authority in accordance with their appropriate supervisory office's guidance.<sup>31</sup> Significant developments regarding the

external auditing program should be communicated promptly to the appropriate supervisory office. Examples of those developments include the hiring of an independent public accountant or other third party to perform external auditing work and a change in, or termination of, an independent public accountant or other external auditor.

### Definitions

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

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

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

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

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

31. When an institution's financial information is included

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

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

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

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

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

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

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

*Financial statements.* The statements of financial position (balance sheet), income, cash flows,

and changes in equity together with related notes.

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

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

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

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

*Reporting by an independent public accountant on an institution's internal control structure over financial reporting.* Under this engagement, management evaluates and documents its review of the effectiveness of the institution's internal control over financial reporting in the identified risk areas as of a specific report date. Management prepares a written assertion, which



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

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

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

*Issued by the FFIEC on September 28, 1999.*

## UNSAFE AND UNSOUND USE OF LIMITATION OF LIABILITY PROVISIONS IN EXTERNAL AUDIT ENGAGEMENT LETTERS

On February 9, 2006, the Federal Reserve and the other financial institution regulatory agencies (the agencies)<sup>32</sup> issued an interagency advisory (the advisory) to address safety-and-soundness concerns that may arise when financial institutions enter into external audit contracts (typically referred to as *engagement letters*) that limit the auditors' liability for audit ser-

vices.<sup>33</sup> The advisory informs financial institutions'<sup>34</sup> boards of directors, audit committees, management, and external auditors of the safety-and-soundness implications that may arise when the financial institution enters into engagement letters that contain provisions to limit the auditors' liability. Such provisions may weaken the external auditors' objectivity, impartiality, and performance and, thus, reduce the agencies' ability to rely on audits. Therefore, certain limitation-of-liability provisions (described in the advisory) are unsafe and unsound. In addition, such provisions may not be consistent with the auditor-independence standards of the SEC, the PCAOB, and the AICPA.

The advisory does not apply to previously executed engagement letters. However, any financial institution subject to a multiyear audit engagement letter containing unsafe and unsound limitation-of-liability provisions should seek an amendment to its engagement letter to be consistent with the advisory for periods ending in 2007 or later. (See SR-06-4.)

## Scope of the Advisory on Engagement Letters

The advisory applies to engagement letters between financial institutions and external auditors with respect to financial-statement audits, audits of internal control over financial reporting, and attestations on management's assessment of internal control over financial reporting (collectively, *audit* or *audits*).

The advisory does not apply to—

- nonaudit services that may be performed by financial institutions' external auditors,
- audits of financial institutions' 401(k) plans, pension plans, and other similar audits,
- services performed by accountants who are not engaged to perform financial institutions' audits (e.g., outsourced internal audits or loan reviews), and
- other service providers (e.g., software consultants or legal advisers).

While the agencies have observed several

32. The Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA).

33. The advisory is effective for audit engagement letters issued on or after February 9, 2006.

34. As used in this advisory, the term *financial institutions* includes banks, bank holding companies, savings associations, savings and loan holding companies, and credit unions.

types of limitation-of-liability provisions in external audit engagement letters, this advisory applies to any agreement that a financial institution enters into with its external auditor that limits the external auditor's liability with respect to audits in an unsafe and unsound manner.

## External Audits and Their Engagement Letters

A properly conducted audit provides an independent and objective view of the reliability of a financial institution's financial statements. The external auditor's objective in an audit is to form an opinion on the financial statements taken as a whole. When planning and performing the audit, the external auditor considers the financial institution's internal control over financial reporting. Generally, the external auditor communicates any identified deficiencies in internal control to management, which enables management to take appropriate corrective action. In addition, certain financial institutions are required to file audited financial statements and internal control audit or attestation reports with one or more of the agencies. The agencies encourage financial institutions not subject to mandatory audit requirements to voluntarily obtain audits of their financial statements. The FFIEC's *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations* notes,<sup>34a</sup> "[a]n institution's internal and external audit programs are critical to its safety and soundness." The policy also states that an effective external auditing program "can improve the safety and soundness of an institution substantially and lessen the risk the institution poses to the insurance funds administered by the FDIC."

Typically, a written engagement letter is used to establish an understanding between the external auditor and the financial institution regarding the services to be performed in connection with the financial institution's audit. The engagement letter commonly describes the objective of the audit, the reports to be prepared, the responsibilities of management and the external auditor, and other significant arrangements (for example, fees and billing). Boards of directors, audit committees, and management are encouraged to closely review all of the provisions in the audit engagement letter before agreeing to sign. As

with all agreements that affect a financial institution's legal rights, the financial institution's legal counsel should carefully review audit engagement letters to help ensure that those charged with engaging the external auditor make a fully informed decision.

The advisory describes the types of objectionable limitation-of-liability provisions and provides examples.<sup>35</sup> Financial institutions' boards of directors, audit committees, and management should also be aware that certain insurance policies (such as error and omission policies and directors' and officers' liability policies) might not cover losses arising from claims that are precluded by limitation-of-liability provisions.

## Limitation-of-Liability Provisions

The provisions of an external audit engagement letter that the agencies deem to be unsafe and unsound can be generally categorized as follows: a provision within an agreement between a client financial institution and its external auditor that effectively—

- indemnifies the external auditor against claims made by third parties;
- holds harmless or releases the external auditor from liability for claims or potential claims that might be asserted by the client financial institution, other than claims for punitive damages; or
- limits the remedies available to the client financial institution, other than punitive damages.

Collectively, these categories of provisions are referred to in this advisory as *limitation-of-liability-provisions*.

Provisions that waive the right of financial institutions to seek punitive damages from their external auditor are not treated as unsafe and unsound under the advisory. Nevertheless, agree-

35. In the majority of external audit engagement letters reviewed, the agencies did not observe provisions that limited an external auditor's liability. However, for those reviewed external audit engagement letters that did have external auditor limited-liability provisions, the agencies noted a significant increase in the types and frequency of the provisions. The provisions took many forms, which made it impractical for the agencies to provide an all-inclusive list. Examples of auditor limitation-of-liability provisions are illustrated in the advisory's appendix A, which can be found in section A.1010.1 of this manual.

34a. See 64 Fed. Reg. 52319 (September 28, 1999).

ments by clients to indemnify their auditors against any third-party damage awards, including punitive damages, are deemed unsafe and unsound under the advisory. To enhance transparency and market discipline, public financial institutions that agree to waive claims for punitive damages against their external auditors may want to disclose annually the nature of these arrangements in their proxy statements or other public reports.

Many financial institutions are required to have their financial statements audited, while others voluntarily choose to undergo such audits. For example, federally insured banks with \$500 million or more in total assets are required to have annual independent audits.<sup>36</sup> Furthermore, financial institutions that are public companies<sup>37</sup> must have annual independent audits. The agencies rely on the results of audits as part of their assessment of a financial institution's safety and soundness.

For audits to be effective, the external auditors must be independent in both fact and appearance, and they must perform all necessary procedures to comply with auditing and attestation standards established by either the AICPA or, if applicable, the PCAOB. When financial institutions execute agreements that limit the external auditors' liability, the external auditors' objectivity, impartiality, and performance may be weakened or compromised, and the usefulness of the audits for safety-and-soundness purposes may be diminished.

By their very nature, limitation-of-liability provisions can remove or greatly weaken external auditors' objective and unbiased consideration of problems encountered in audit engagements and may diminish auditors' adherence to the standards of objectivity and impartiality required in the performance of audits. The existence of such provisions in external audit engagement letters may lead to the use of less extensive or less thorough procedures than would otherwise be followed, thereby reducing the reliability of audits. Accordingly, financial institutions should not enter into external audit arrangements that include unsafe and unsound limitation-of-liability provisions identified in the advisory, regardless of (1) the size of the financial institution, (2) whether the financial institu-

tion is public or not, or (3) whether the external audit is required or voluntary.

## Auditor Independence

Currently, auditor-independence standard-setters include the SEC, PCAOB, and AICPA. Depending on the audit client, an external auditor is subject to the independence standards issued by one or more of these standard-setters. For all nonpublic financial institutions that are not required to have annual independent audits, the FDIC's rules, pursuant to part 363, require only that an external auditor meet the AICPA independence standards. The rules do not require the financial institution's external auditor to comply with the independence standards of the SEC and the PCAOB.

In contrast, for financial institutions subject to the audit requirements in part 363 of the FDIC's regulations, the external auditor should be in compliance with the AICPA's Code of Professional Conduct and meet the independence requirements and interpretations of the SEC and its staff.<sup>38</sup> In this regard, in a December 13, 2004, frequently asked question (FAQ) on the application of the SEC's auditor-independence rules, the SEC staff reiterated its long-standing position that when an accountant and his or her client enter into an agreement that seeks to provide the accountant immunity from liability for his or her own negligent acts, the accountant is not independent. The FAQ also stated that including in engagement letters a clause that would release, indemnify, or hold the auditor harmless from any liability and costs resulting from knowing misrepresentations by management would impair the auditor's independence.<sup>39</sup> The FAQ is consistent with the SEC's Codification of Financial Reporting Policies, section 602.02.f.i, "Indemnification by Client." (See section A.1010.1 of this manual.)

On the basis of the SEC guidance and the agencies' existing regulations, certain limits on

38. See part 363 of the FDIC's regulation (12 CFR 363), *Appendix A—Guidelines and Interpretations*, Guideline 14, "Role of the Independent Public Accountant-Independence."

39. In contrast to the SEC's position, AICPA Ethics Ruling 94 (ET, section 191.188–189) currently concludes that indemnification for "knowing misrepresentations by management" does not impair independence.

36. For banks, see section 36 of the FDI Act (12 USC 1831m) and part 363 of the FDIC's regulations (12 CFR 363).

37. Public companies are companies subject to the reporting requirements of the Securities Exchange Act of 1934.

auditors' liability are already inappropriate in audit engagement letters entered into by—

- public financial institutions that file reports with the SEC or with the agencies,
- financial institutions subject to part 363, and
- certain other financial institutions that are required to have annual independent audits.

In addition, certain of these limits on auditors' liability may violate the AICPA independence standards. Notwithstanding the potential applicability of auditor-independence standards, the limitation-of-liability provisions discussed in the advisory present safety-and-soundness concerns for all financial institution audits.

### Alternative Dispute-Resolution Agreements and Jury-Trial Waivers

The agencies observed that a review of the engagement letters of some financial institutions revealed that they had agreed to submit disputes over external audit services to mandatory and binding alternative dispute resolution, binding arbitration, or other binding nonjudicial dispute-resolution processes (collectively, *mandatory ADR*) or to waive the right to a jury trial. By agreeing in advance to submit disputes to mandatory ADR, financial institutions may waive the right to full discovery, limit appellate review, or limit or waive other rights and protections available in ordinary litigation proceedings.

Mandatory ADR procedures and jury-trial waivers may be efficient and cost-effective tools for resolving disputes in some cases. Accordingly, the agencies believe that mandatory ADR or waiver of jury-trial provisions in external audit engagement letters do not present safety-and-soundness concerns, provided that the engagement letters do not also incorporate limitation-of-liability provisions. Institutions are encouraged to carefully review mandatory ADR and jury-trial provisions in engagement letters, as well as review any agreements regarding rules of procedure, and to fully comprehend the ramifications of any agreement to waive any available remedies. Financial institutions should ensure that any mandatory ADR provisions in audit engagement letters are commercially reasonable and—

- apply equally to all parties,

- provide a fair process (for example, neutral decision makers and appropriate hearing procedures), and
- are not imposed in a coercive manner.

### The Advisory's Conclusion

Financial institutions' boards of directors, audit committees, and management should not enter into any agreement that incorporates limitation-of-liability provisions with respect to audits. In addition, financial institutions should document their business rationale for agreeing to any other provisions that limit their legal rights.

The inclusion of limitation-of-liability provisions in external audit engagement letters and other agreements that are inconsistent with the advisory will generally be considered an unsafe and unsound practice. Examiners will consider the policies, processes, and personnel surrounding a financial institution's external auditing program in determining whether (1) the engagement letter covering external auditing activities raises any safety-and-soundness concerns and (2) the external auditor maintains appropriate independence regarding relationships with the financial institution under relevant professional standards. The agencies may take appropriate supervisory action if unsafe and unsound limitation-of-liability provisions are included in external audit engagement letters or other agreements related to audits that are executed (accepted or agreed to by the financial institution).

## CERTIFIED PUBLIC ACCOUNTANTS

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

### Standards of Conduct

The Code of Professional Ethics for CPAs who are members of the American Institute of Certified Public Accountants (AICPA) requires that audits be performed according to generally accepted auditing standards (GAAS). GAAS, as distinct from generally accepted accounting principles, or GAAP, are concerned with the audi-

tor's professional qualifications, the judgment the auditor exercises in the performance of an audit, and the quality of the audit procedures.

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

## Generally Accepted Auditing Standards

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

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

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

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

GAAS recognizes that management—not the CPA—has primary responsibility for the prepa-

ration of the financial statements and the presentations therein. The auditor's responsibility is to express an opinion on the financial statements. GAAS (or the audit requirements previously set forth) require that audits cover the following financial statements: balance sheet, income statement, statement of changes in stockholders' equity, and statement of cash flows.

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

## Independence

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

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

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

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

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

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

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

## EXTERNAL AUDIT REPORTS

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

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

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

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

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

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

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

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

## REVIEW OF THE EXTERNAL AUDITOR'S INDEPENDENCE AND AUDIT

Because of the professional and ethical standards of the public accounting profession, the Federal Reserve has concluded that the examiner should conduct an in-depth review of the competence and independence of the CPA only

in unusual situations. One such situation would be a recent change in CPAs by a bank, particularly if the change was made after an audit had commenced.

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

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

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

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

Under certain circumstances, a CPA may issue a qualified or adverse opinion or may disclaim an opinion on a bank's financial statements. In such circumstances, the examiner should first determine the reasons for the particular type of opinion issued. If the matters involved affect specific areas of the bank's operations, a review of the work performed by the CPA may help the examiner understand the problem that gave rise to this opinion. The examination procedures (section 1010.3) describes the steps the examiner should follow when conducting a review of the work performed by the CPA. (See the FFIEC interagency Policy Statement on the External Auditing Pro-

grams of Banks and Savings Associations (effective January 1, 2000) (SR-99-33)).

## LIMITATIONS OF AUDITS AND AUDITED FINANCIAL STATEMENTS

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

- The auditor is not responsible for deciding whether an institution operates wisely. An unqualified audit report means that the transactions and balances are reported in accordance with GAAP. It does not mean that the transactions made business sense, that the associated risks are managed in a safe and sound manner, or that the balances can be recovered upon disposition or liquidation.
- The auditor's report concerning financial statements does not signify that underwriting standards, operating strategies, loan-monitoring systems, and workout procedures are adequate to mitigate losses if the environment changes. The auditor's report that financial statements fairly present the bank's financial position is based on the prevailing evidence and current environment, and it indicates that reported assets can be recovered in the normal course of business. In determining that reported assets can be recovered in the normal course of business, the auditor attempts to understand financial-reporting internal controls and can substitute other audit procedures when these controls are weak or nonexistent.
- The quality of management and how it manages risk are not considered in determining historical cost and its recoverability. Although certain assets and instruments are marked to market (for example, trading accounts), GAAP generally uses historical cost as the basis of presentation. Historical cost assumes that the entity is a going concern. The going-concern concept allows certain mark-to-market losses

to be deferred because management believes the cost basis can be recovered during the remaining life of the asset.

- GAAP financial statements offer only limited disclosures of risks, uncertainties, and the other safety-and-soundness factors on which the institution's viability depends.
- Under GAAP, loan-loss reserves are provided for "probable losses" currently "inherent" (that is, anticipated future charge-offs are based on current repayment characteristics) in the portfolio. GAAP defines probable as the likelihood that a future event will occur, confirming the fact of the loss. Additionally, the amount of the loss must be reasonably estimable.

## COMMUNICATION WITH EXTERNAL AUDITORS

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

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

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

The 1992 interagency policy statement was issued to improve coordination and communica-

tion between external auditors and examiners. Examination personnel should provide banking organizations with advance notice of the starting date of the examination when appropriate, so management can inform external auditors in advance and facilitate the planning and scheduling of their audit work.

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

## Meetings and Discussions Between External Auditors and Examiners

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

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

## Information Required to Be Made Available to External Auditors

Section 931 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and section 112 of FDICIA (12 USC 1811) pertain to depository institutions insured by the FDIC that have engaged the services of an external auditor to audit the banking organi-



zation within the past two years. FIRREA and FDICIA require banks to provide the auditor with copies of the most recent Report of Condition (Call Report), report of examination, and pertinent correspondence or reports received from its regulator. This information is to be provided to the external auditor by the bank under audit, not by the FRB. In addition, banking organizations must provide the independent auditor with—

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

Regulatory personnel should ascertain if the banking organization is in compliance with the

requirements of section 931 of FIRREA (12 USC 1817(a)) and section 112 of FDICIA and should report instances of noncompliance in the report of examination.

### Confidentiality of Supervisory Information

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

# Internal Control and Audit Function, Oversight, and Outsourcing Examination Objectives

Effective date May 2006

## Section 1010.2

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1. To determine whether internal and external audit functions exist.
2. To determine with reasonable assurance that the bank has an adequate internal audit function that ensures efficient and effective operations, including the safeguarding of assets, reliable financial reporting, and compliance with applicable laws and regulations.
3. To ascertain, through the examination process, that the bank's internal audit function monitors, reviews, and ensures the continued existence and maintenance of sound and adequate internal controls over the bank's management process—the control environment, risk assessment, control activities, information and communication, and monitoring activities.
4. To review and evaluate internal audit outsourcing arrangements and the actions of the outsourcing vendor under the standards established by the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing.
5. To evaluate the independence and competence of those who provide the internal and external audit functions.
6. To consider the policies, processes, and personnel surrounding the bank's external auditing program and to determine if—
  - a. any engagement letter or other agreement related to external audit activities for the bank (1) provides any assurances of indemnification to the bank's external auditors that relieves them of liability for their own negligent acts (including any losses, claims, damages, or other liabilities) or (2) raises any other safety- and soundness-concerns; and
  - b. the external auditors have maintained appropriate independence in their relationships with the bank, in accordance with relevant professional standards.
7. To determine the adequacy of the procedures performed by the internal and external auditors.
8. To determine, based on the criteria above, if the work performed by internal and external auditors is reliable.

# Internal Control and Audit Function, Oversight, and Outsourcing Examination Procedures

Effective date May 2006

## Section 1010.3

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

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

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

### INTERNAL AUDITORS

1. *Organizational structure of the audit department.* Review the bylaws and the organization chart of the bank and the minutes of the board's audit or examining committee to determine how effectively the board of directors is discharging its responsibility.
2. *Independence of the audit function.* Interview the auditor and observe the operation of the audit department to determine its functional responsibilities.
3. *Auditors' qualifications.* Review biographical data and interview the auditor to determine his or her ability to manage the auditor's responsibility in the bank.

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

### INTERNAL AUDIT FUNCTION ADEQUACY

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

ing internal-external audit report comments with the internal audit manager or other person responsible for reviewing the system of internal control. If these discussions do not resolve the examiner's comments and concerns, bring these matters to the attention of senior management and the board of directors or the audit committee.

3. If material weaknesses in the internal audit function or the internal control system exist, discuss them with appropriate Federal Reserve Bank supervisory staff to determine the appropriate actions (including formal and informal enforcement actions) that should be taken to ensure that the bank corrects the deficiencies.
4. Incorporate conclusions about the bank's internal audit function into the bank's management and composite supervisory ratings.
5. Include in the report of examination comments concerning the adequacy of the internal audit function, significant issues or concerns, and recommended corrective actions.

## INDEPENDENCE OF THE OUTSOURCING VENDOR

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

to be compromised, discuss the examination findings and the supervisory actions that may be taken with the bank's senior management, board of directors (or audit committee), and the external auditor or other vendor.

## EXTERNAL AUDITORS

1. If the bank has engaged any external audit firms to conduct audits of its financial statements (including their certification), audits of internal control over financial reporting, attestations on management's assessment of internal control, appraisals of the bank's audit function, any internal audit or audit function or operational review, review any pending or past engagement letters and agreements. Determine if the audit engagement letters or other agreements include unsafe and unsound provisions that—
  - a. indemnify the external auditor against all claims made by third parties;
  - b. hold harmless, release, or indemnify the external auditor from liability for claims or potential claims that the bank may assert (other than claims for punitive damages), thus providing relief from liability for the auditors' own negligent acts, including any losses, claims, damages, or other liabilities; or
  - c. limit the remedies available to the bank (other than punitive damages).
2. Find out whether the bank's board of directors, audit committee, and senior management closely review all of the provisions of audit engagement letters or other agreements for providing external auditing services for the bank before agreeing to sign them, thus indicating the bank's approval and financial commitment.
3. Verify that the bank has documented its business rationale for any engagement letter or other agreement provisions with external audit firms that limit or impair the bank's legal rights.
4. With the cooperation of the audit committee, review and determine the adequacy of the bank's external auditors' reports, letters, or correspondence, including their supporting workpapers, for the audit work performed since the previous examination.

**REGULATORY EXAMINATIONS**

1. Review any functional regulatory examination or supervisory examination report for work performed since the previous state

member bank examination. Interview any involved auditors to determine their responsibilities and extent of involvement with the work in this area.

# Internal Control and Audit Function, Oversight, and Outsourcing

## Audit Function Questionnaire

Effective date May 2006

Section 1010.4

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

### ORGANIZATIONAL STRUCTURE AND INTERNAL CONTROL ENVIRONMENT OF THE AUDIT DEPARTMENT

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

quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance?

### INDEPENDENCE AND MANAGEMENT OF THE AUDIT FUNCTION

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

### AUDITOR'S QUALIFICATIONS

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

- in duration to that required of the officers assigned major responsibilities?
4. Does the auditor communicate and relate well with all levels of personnel?
  5. Does the auditor demonstrate a commitment to continuing education and a current knowledge of the latest developments in banking and auditing technology?
  6. Is the auditor dedicated to the standards and ethics of his or her profession (such as those published by the Bank Administration Institute, the Institute of Internal Auditors, and the American Institute of Certified Public Accountants)?
6. Does the frequency and scope schedule require approval by the audit committee, the board of directors, regulatory authorities, or others? If so, by whom, and has such approval been obtained?
  7. Does the frequency and scope schedule comply with state statutory requirements, if any, for internal audits, including minimum audit standards?
  8. Does the auditor periodically report his or her progress in completing the frequency and scope schedule to the board's audit committee?
    - a. If not to the board's audit committee, to whom?
    - b. Does the committee approve significant deviations, if any, in the original program?
  9. Does the auditor prepare a time budget? Are budgeted versus actual time analyses used as a guide in forward planning?
  10. Does the depth of coverage appear to be sufficient?
  11. Are different entry dates and time periods between reviews scheduled so as to frustrate reliable anticipation of entry dates by auditees?
  12. Is the bank's possession of all assets owned or managed in fiduciary capacities subjected to verification?
  13. Are controls on opening and closing general ledger and subsidiary accounts adequate and is the auditor formally advised of any changes?
  14. If the bank has automated systems, does the program call for the application of independently prepared computer programs that employ the computer as an audit tool?
  15. Will the audit staff examine the documentation of all bank systems and produce their own documentation?
  16. Are all service-related activities not specifically manifested in general ledger accounts subject to adequate periodic review (for example, supervisory regulations, security, vacation policy, purchases, traveler's checks, and safekeeping)?
  17. Will appraisals of administrative control be made for each function, yielding audit comments and suggestions for improvements of operational efficiency?

## AUDIT STAFF QUALIFICATIONS

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

## CONTENT AND USE OF THE AUDIT FREQUENCY AND SCOPE SCHEDULE

1. Is the audit program formalized and therefore on record as a commitment that can be analyzed and reviewed?
2. Are all important bank functions and services identified as subjects of the audits?
3. Does the audit program include procedures necessary to ensure compliance with the Federal Election Campaign Act and the Foreign Corrupt Practices Act?
4. Does the internal audit department have access to all reports, records, and minutes?
5. Are internal audit activities adjusted for significant changes in the bank's environment, structure, activities, risk exposures, or systems?

## AUDIT DEPARTMENT PARTICIPATION IN SYSTEMS DESIGN PROJECTS

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

## AUDIT MANUAL

1. Has responsibility for the establishment and maintenance of the audit manual been clearly assigned?
2. Does the audit manual require approval by the board of directors, the audit committee, or others? If so, has such approval been obtained?
3. Is the content of the audit manual independent from adverse influence by other interests, such as operating management or independent CPAs?
4. Is the audit manual current, and are procedures for keeping the manual current adequate?
5. Does the audit manual contain the scope and objective of each audit?
6. Does the manual provide for valid deviations from audit procedures to be officially approved by audit management?
7. Do audit procedures provide for the follow-up of exceptions noted in previous audits?
8. Does the manual prescribe that each audit procedure be cross-referenced to the appropriate audit workpapers?
9. Must an auditor initial each program step as testimony of his or her performance?

10. Does the manual prescribe that full control be established at the time of entry over the records selected for audit?
11. Is proof of subsidiary to control records required?
12. Are subsidiary direct verification programs covering all forms of customer deposit, loan, safekeeping, collateral, collection, and trust accounts included?
13. Are flow charts called for as evidence of thorough analytical auditing?
14. Do the procedures employ scientific sampling techniques that have acceptable reliability and precision?
15. Does the audit manual provide for the resolution of exceptions and deficiencies?
16. Does the audit manual contain provisions for report format and content and an expression of the opinion of the auditor regarding the adequacy, effectiveness, and efficiency of internal controls?
17. For each audit, do audit procedures provide for a documented method of assuring audit management that a proper study and evaluation of existing internal controls has been made, such as an internal control questionnaire or memorandum?
18. Does the audit manual contain a provision for a review and update of the procedures for each audit, where required, upon the audit's completion?
19. Does the audit manual provide for the maintenance of a permanent file for audits conducted?
20. Does the audit manual contain provisions for the formal, standardized preparation and maintenance of workpapers?
21. Are applicable statutory and regulatory requirements included in the audit procedures?

## MAINTENANCE OF AUDIT RECORDS

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



4. Do the workpapers contain evidence that all significant deviations from standard audit procedures are documented and have received the approval of audit management?
  5. Are procedures for preparing and maintaining workpapers being adhered to?
  6. Do workpapers adequately document the internal audit work performed and support the audit reports?
  7. Do workpapers contain a copy of the audit report, an adequate index, an internal control questionnaire, audit procedures, and other appropriate material?
  8. Are workpapers numbered, indexed, and cross-referenced to audit procedures and the workpapers index?
  9. Is each workpaper dated and initialed by the preparer?
    - a. Are sources of data clearly shown?
    - b. Are tick marks explained?
  10. From the workpapers, can it be determined how various sample sizes were determined (by judgment or statistical sampling), including the range and confidence level?
  11. Do workpapers contain evidence that supervisory personnel of the audit department have reviewed the workpapers and resultant findings?
  12. Are all significant or unresolved exceptions noted in workpapers required to be included in the report?
  13. Are applicable statutory and regulatory requirements being complied with?
- differences of opinion between audit and operating management effective?
4. Does the auditor maintain a formal record of all audit reports that contain unresolved recommendations and exceptions?
  5. Does the bank promptly respond to significant identified internal control weaknesses? Are exceptions and recommendations generally resolved within 90 days?
  6. Are audit reports submitted promptly?
  7. Are responses received promptly?

## USE AND EFFECTIVENESS OF AUDIT COMPUTER PROGRAMS

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

## AUDIT DEPARTMENT'S FORMAL REPORTING PROCEDURES

1. Does the auditor submit formal reports? If so, to whom?
2. Do the reports convey to the reader the auditor's general observation of the condition of the operation of the department or function?
  - a. Do they adequately reflect the scope of the audit?
  - b. Do they contain an opinion of the auditor regarding the adequacy, effectiveness, and efficiency of internal controls?
  - c. Do they call for a prompt response, where appropriate?
3. With regard to audit exceptions and recommendations, is the method of resolving

## INTERNAL AUDIT OUTSOURCING ARRANGEMENTS

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

- terms of the service contract, especially for expansion of audit work if significant issues are found, and contain stipulations for default and termination of the contract?
- e. state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vendor?
  - f. specify the locations of internal audit reports and the related workpapers?
  - g. specify the period of time (for example, seven years) that vendors must maintain the workpapers?<sup>1</sup>
  - h. state that outsourced internal audit services provided by the vendor are subject to regulatory review and that examiners will be granted full and timely access to the internal audit reports and related workpapers prepared by the outsourcing vendor?
  - i. prescribe a process (arbitration, mediation, or other means) for resolving disputes and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence?
  - j. state that the outsourcing vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee and, if applicable, will comply with AICPA, SEC, Public Company Accounting Oversight Board (PCAOB), or regulatory independence guidance?
3. Does the outsourced internal audit arrangement maintain or improve the quality of the internal audit function and the bank's internal control?
  4. Do key employees of the bank and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed?
  5. Is the scope of the outsourced work revised appropriately when the bank's environment, structure, activities, risk exposures, or systems change significantly?
  6. Have the directors ensured that the outsourced internal audit activities are effectively managed by the bank?
  7. Does the arrangement with the outsourcing vendor satisfy the independence standards described in the Policy Statement on the Internal Audit Function and Its Outsourcing and thereby preserve the independence of the internal audit function, whether or not the vendor is also the bank's independent public accountant?
  8. Has the bank performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement, and are there adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement?
  9. Does the bank have a contingency plan to ensure continuity in audit coverage, especially for high-risk areas?

## EXTERNAL AUDIT ENGAGEMENT LETTERS AND OTHER AUDIT AGREEMENTS

1. Does the bank's board of directors, audit committee, and senior management closely review all of the provisions in audit engagement letters or other audit work agreements before agreeing to sign them?
2. Does the bank's legal counsel carefully review audit engagement letters to ensure that those charged with engaging the external auditor make a fully informed decision?
3. Does the bank have any engagement letters for audits of financial statements, audits of internal control over financial reporting, or attestations on management's assessment of internal control that include unsafe and unsound provisions that—
  - a. indemnify the external auditor against all claims made by third parties?
  - b. hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution (other than claims for punitive damages)?
  - c. limit the remedies available to the client

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

financial institution (other than punitive damages)?

4. Has the bank agreed in any engagement letters or other audit work agreements to submit disputes over external audit services to mandatory and binding alternative dispute resolution, binding arbitration, or other binding nonjudicial dispute-resolution processes (collectively, *mandatory ADR*) or to waive the right to a jury trial. If so—
  - a. has the bank's senior management carefully reviewed mandatory ADR and jury-trial provisions in engagement letters, as well as reviewed any agreements regarding rules of procedure, in order to fully comprehend the ramifications of any agreement to waive any available remedies?
  - b. has the bank's senior management obtained written assurances that its insurance policies (for example, the bank's errors and omissions policies and directors' and officers' liability policies) will cover losses from claims that are precluded by limitation-of-liability provisions in audit engagement letters or other audit agreements?
5. Has the bank's senior management ensured that any mandatory ADR provisions in audit engagement letters are commercially reasonable and—
  - a. apply equally to all parties?
  - b. provide a fair process (e.g., neutral decision makers and appropriate hearing procedures)?
  - c. are not imposed in a coercive manner?
6. Has the bank's board of directors, audit committee, or senior management documented their business rationale for agreeing to any provisions that limit their legal rights?

## EXTERNAL AUDIT ACTIVITIES

1. When state, federal, or supervisory regulations or stock-exchange listing require

an independent CPA audit, did the bank comply?

- a. If so, was the opinion rendered by the accounting firm unqualified?
  - b. If not, has the auditor taken appropriate action to resolve any deficiencies?
2. Does the bank policy prohibit loans to its external auditor or the engagement of an external auditor who is a stockholder? If not, has the board considered the materiality of any existing transactions regarding the auditor's independence?
  3. Has an external auditor been engaged to perform special reviews of specific departments or areas of the bank since the previous examination? If deficiencies were cited, have they been corrected?
  4. Has the same public accounting firm been engaged for the prior two years? If not, obtain a reason for change.
  5. Have management letters from the external auditors or other reports from consultants been presented to management since the last examination?
  6. Do deficiencies in management letters receive appropriate attention?
  7. Are the notes pertaining to the financial statements reviewed for any information that may allude to significant accounting or control problems?
  8. Does the report of examination or the management letter submitted by the public accounting firm comprehensively define the scope of the examination conducted?

## REGULATORY EXAMINATION ACTIVITIES

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

The Federal Reserve System (System) maintains a long-standing policy that compels System employees, including examiners, to avoid any action that may result in an employee (or create the appearance that an employee) is—

- using his or her Federal Reserve position for private gain,
- giving preferential treatment to any person or institution,
- losing independence or impartiality, or
- making decisions outside of official channels.

Federal Reserve examiners are also subject to conflict-of-interest rules that are designed to ensure (1) both the objectivity and integrity of bank examinations and (2) that Federal Reserve examiners comply with criminal statutory prohibitions.

The conflict-of-interest rules are set forth in section 5 of the *Federal Reserve Administrative Manual* and in each Reserve Bank's uniform codes of conduct.

### EXAMINER BORROWING RULES

A bank examiner is prohibited from accepting a loan or gratuity from any bank examined by the individual (18 USC 213). An officer, director, or employee of a bank is prohibited from making or granting any loan or gratuity to any examiner who examines or has authority to examine the bank (18 USC 212). These statutory provisions may also be applicable to a loan obtained by a System employee who has been issued a special, temporary, or ad hoc examiner credential. An examiner found to be in violation of these provisions can be—

- fined under title 18 of the U.S. Code (Crimes and Criminal Procedure), imprisoned not more than one year, or both;
- further fined a sum equal to the money loaned or gratuity given; and
- disqualified from holding office as an examiner.

On February 3, 2005, the director of the Board's Division of Banking Supervision and Regulation and the Board's general counsel, acting under delegated authority, approved changes to the System's examiner borrowing

rules as a result of the Preserving Independence of Financial Institution Examinations Act of 2003 (18 USC 212–213). The act included provisions that liberalized examiner borrowing restrictions by providing narrow exceptions that enable bank examiners to obtain credit cards and certain home mortgage loans from a broader range of lenders. (See SR-05-2.)

Under the act, a Reserve Bank examiner may accept a credit card or a loan secured by a mortgage on the examiner's principal residence from an institution supervised by the Federal Reserve, as long as the examiner meets the financial requirements to obtain such credit or loan. The terms of the credit or loan cannot be more favorable than the terms that are generally offered to other borrowers. Federal Reserve policy, however, does not permit examiners to participate in the examination of any banking organization from which they have obtained home mortgage loans.

### POST-EMPLOYMENT RESTRICTIONS FOR “SENIOR EXAMINERS”

On November 17, 2005, the federal bank regulatory agencies<sup>1</sup> adopted a rule (effective December 17, 2005) to implement the post-employment restriction found in the Intelligence Reform and Terrorism Prevention Act of 2004 (see 12 USC 1820).<sup>2</sup> (See the Board's rules at 12 CFR 263 and 264, as well as SR-05-26 and its attachments.) The restriction prohibits an examiner who served as a “senior examiner” for a depository institution or depository institution holding company for two or more months during the examiner's final twelve months of employment with a Reserve Bank from knowingly accepting compensation as an employee, an officer, a director, or a consultant from that depository institution or holding company, or from certain related entities.<sup>3</sup> *The rule is expected to affect a*

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

2. Pub. L. 108-458, 118 Stat. 3638, 3751–53 (December 17, 2004).

3. The Board's rule applies to a covered examiner who leaves the Federal Reserve's service after December 17, 2005. Because the statute has a one-year look-back provision, an

*relatively small number of Federal Reserve examiners, primarily the “central points of contact” (CPC) or other examiners in functionally equivalent positions for the largest and most complex institutions.* Table 1 summarizes how the restriction applies to “senior examiners” of the different types of organizations within the Federal Reserve’s jurisdiction.

### Definition of “Senior Examiner”

For purposes of this rule, an officer or employee of the Federal Reserve is considered to be the “senior examiner” for a particular state member bank, bank holding company, or foreign bank if the individual meets all of the following criteria:

- The officer or employee has been authorized by the Board to conduct examinations or inspections on behalf of the Board.
- The officer or employee has been assigned continuing, broad, and lead responsibility for examining or inspecting that state member bank, bank holding company, or foreign bank.
- The officer’s or employee’s responsibilities for examining, inspecting, and supervising the state member bank, bank holding company, or foreign bank—
  - represent a substantial portion of the officer’s or employee’s assigned responsibilities and
  - require the officer or employee to interact routinely with officers or employees of the

state member bank, bank holding company, or foreign bank or its respective affiliates.

The rule does not cover an examiner who performs only periodic, short-term examinations of a depository institution or holding company and who does not have ongoing, continuing responsibility for the institution or holding company. The rule also does not cover an examiner who spends a substantial portion of his or her time conducting or leading a targeted examination (such as a review of an institution’s credit-risk management, information systems, or internal audit functions) and who does not have broad and lead responsibility for the overall examination program for the institution or holding company.

The restriction applies to a covered individual for one year after the individual terminates his or her employment with the Reserve Bank. If an examiner violates the one-year restriction, the statute requires the appropriate federal banking agency to seek an order of removal and industry-wide employment prohibition, a civil money penalty of up to \$250,000, or both. In special circumstances, the Chairman of the Board of Governors may waive the restriction for the “senior examiner” of the Federal Reserve by certifying in writing that granting the individual a waiver of the restriction would not affect the integrity of the Federal Reserve’s supervisory program.

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examiner’s responsibilities from as far back as December 17, 2004, may subject the “senior examiner” to the post-employment restriction.

**Table 1—Summary of Prohibited Employment Based on Examination Responsibility**

<i>Examiner Responsibility</i>	<i>Restriction</i>
If during two or more months of the last twelve months of service, the examiner serves as the “senior examiner” for a—	Then for one year after leaving the Reserve Bank, the “senior examiner” may not knowingly accept compensation as an employee, officer, director, or consultant from—
State member bank	<ul style="list-style-type: none"> <li>• the state member bank (including any subsidiary of the state member bank) or</li> <li>• any company (including a bank holding company) that controls the state member bank.</li> </ul>
Bank holding company	<ul style="list-style-type: none"> <li>• the bank holding company or</li> <li>• any depository institution controlled by the bank holding company (including any subsidiary of the depository institution).</li> </ul>
Foreign bank	<ul style="list-style-type: none"> <li>• the foreign bank,</li> <li>• any U.S. branch or agency of the foreign bank, or</li> <li>• any U.S. depository institution controlled by the foreign bank (including any subsidiary of the depository institution).</li> </ul>

# Federal Reserve System Bank Watch List and Surveillance Programs

Effective date May 2006

## Section 1020.1

The Federal Reserve System (the System) uses automated screening systems to conduct routine monitoring of the financial condition and performance of state member banks. These surveillance systems rely on Call Reports and other financial regulatory reports, as well as examination data, to identify institutions exhibiting financial deterioration or increased risk profiles. This surveillance process ensures that these banks receive timely supervisory attention and that examination resources can be directed to weak and potentially troubled banks to supplement on-site examinations.

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

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

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

1. *A set of System monitoring screens of financial data.* The process, referred to as "screening," involves a routine monitoring of the financial condition, performance, and risk of banks.
2. *Analysis based on the watch list and other reports.* System staff use the watch list and other data derived from the surveillance process to flag outlier institutions, using mea-

asures that correspond to areas of supervisory concern. The monitoring screens and watch list are designed and used to spot trends and changes in an institution's financial condition and performance to determine if identified companies require further review.

3. *Corrective action and follow-up.* Reserve Bank follow-up action is performed for outlier institutions. The nature and extent of follow-up depend on current conditions at the identified bank. Actions range from completing a written analysis of the factors contributing to the outlier status to conducting an on-site examination. These efforts ensure that identified problems are monitored until they can be corrected or resolved.

### SYSTEM BANK WATCH LIST PROGRAM

The State Member Bank Watch List Program, detailed in SR-06-2, "Enhancements to the System's Off-Site Bank Surveillance Program," is the Federal Reserve's primary means for monitoring state member bank performance and condition between on-site examinations. The watch list is a record of banks that failed selected monitoring screens or ratings criteria. The watch list helps the Reserve Banks track and address troubled or potentially weak banks and identify common supervisory issues in the banks meeting watch list criteria. The program consists of five phases: (1) generating, reviewing, and modifying a watch list of banks meeting certain inclusion criteria; (2) analyzing the financial condition and risk profile of each bank on the final watch list and specifying the factors responsible for the bank's appearance on the watch list; (3) determining whether the safety-and-soundness examination schedule should be accelerated for those banks listed on the watch list; (4) preparing or updating a surveillance write-up for each bank listed on the watch list; and (5) developing a suitable supervisory response, including possible corrective action, that addresses identified problems.

The Watch List Program applies to all state member banks and includes both state member banks with known weaknesses and those with characteristics that could affect supervisory

assessments of the quality of bank management or of the overall safety and soundness of a bank. The program helps to ensure that weaknesses existing at supervised banks are being addressed appropriately and that potential emerging problems can be promptly identified in between regularly scheduled on-site safety-and-soundness examinations. State member banks are included on a watch list and require quarterly written analyses when they meet any of the following criteria:

- overall Supervision and Regulation Statistical Assessment of Bank Risk (SR-SABR) surveillance rating of 1D, 1F, 2D, or 2F
- CAMELS composite rating of 3 or worse
- Management or Risk Management component rating of 3 or worse
- composite rating in either of the worst two categories under the Trust, Information Technology, Consumer Compliance, or Community Reinvestment Act rating systems

Reserve Banks and Board staff may add state member banks to the watch list for reasons other than those listed above. For example, they may elect to include selected de novo banks, banks reporting rapid asset or loan growth or significant changes in business mix, and other institutions with financial characteristics that suggest the need for heightened off-site monitoring in between on-site examinations.

## SR-SABR Model

The SR-SABR model assigns a two-component surveillance rating to each bank. The first component is the current composite CAMELS rating assigned to the bank. The second component is a letter (A, B, C, D, or F), reflecting the model's assessment of the relative strength or weakness of a bank compared with other institutions within the same CAMELS rating category.<sup>1</sup> An SR-SABR rating that includes an "A" denotes a bank with particularly strong financial and supervisory indicators compared with other banks within its CAMELS rating category. An SR-SABR rating including an "F" indicates that

a bank is reporting poor financial results or showing other signs of significant weakness compared with similarly rated banks. For example, a 1A rating signifies a 1-rated bank that reports strong financial and supervisory indicators when compared with all 1- and 2-rated banks, while a 1F indicates that, while the bank currently maintains the strongest possible composite CAMELS rating, its financial or other supervisory indicators place it among the weakest of the banks currently rated either 1 or 2. SR-SABR ratings that include a "B" generally correspond to banks with financial and supervisory measures that are comparable to most banks in the CAMELS rating category. Those with a "C" have weaker measures than those of most other banks in their CAMELS rating category, and those with a "D" have significantly weaker financial or supervisory measures compared with other banks in their rating category.

Three separate econometric models contribute to SR-SABR surveillance ratings. Two of the models estimate the probability of an adverse supervisory rating change for a bank if it was examined within the next quarter. The first estimates the probability of an adverse rating change for banks currently rated CAMELS 1 or 2. The second estimates the probability of an adverse rating change for banks currently rated 3, 4, or 5.<sup>2</sup> Together, these models are used to assign an "adverse change" rating. They utilize seven financial variables computed using Call Report data and seven supervisory variables that have been statistically significant in explaining adverse ratings assigned over the past three years. The third model is retained from the System to Estimate Examination Ratings (SEER) framework and estimates the probability that a bank will fail or become critically undercapitalized within the next two years. This model is referred to as the "viability" model and includes 11 financial variables computed using Call Report data. The model was estimated and developed based on the financial results from the large group of banks that failed in the late 1980s and early 1990s.

## Quarterly Watch List Procedures

Board staff will distribute a preliminary quarterly watch list to surveillance contacts at each

1. For banks currently rated 1 or 2, "CAMELS rating category" refers to all banks with satisfactory (1 or 2) CAMELS ratings. Banks with less than satisfactory CAMELS ratings are compared only with other banks that have the same CAMELS rating.

2. For 5-rated banks, an adverse rating change is defined as the continuation of the current rating.



Reserve Bank upon the finalization of quarterly Call Report processing. To assist examiners and analysts in interpreting SR-SABR model results, Board staff will also distribute SR-SABR Schedule of Risk Factors (SRFs) reports. The SRFs highlight financial ratios that cause the model to flag a bank as particularly strong or weak. These reports also include peer statistics to highlight the relative position of a bank compared with other institutions that have similar CAMELS composite ratings. In addition, supplemental monitoring screens will be distributed to assist in analyzing watch list banks and in identifying other banks that may require additional supervisory attention.

Upon notification from Board staff that quarterly surveillance materials are ready for review, Reserve Banks should perform the following procedures:

- *Review and modify the watch list.* Review the preliminary watch list and add any other state member banks from their districts that have significant safety-and-soundness weaknesses. For each bank to be added, the Reserve Bank should submit the name, ID RSSD number, location, asset size, and the reasons for its inclusion on the watch list by e-mail to the manager of the Surveillance, Financial Trends, and Analysis Section at the Board within five business days of receiving the preliminary watch list. Reserve Banks also may recommend removal of banks that they previously had added to the watch list and that no longer appear to warrant watch list status. In these cases, the Reserve Bank should also provide a brief written rationale to Board staff for removing any banks from the watch list. Ten days after the distribution of the draft, the watch list will be deemed final, and the time frame for completing all follow-up work will commence.
- *Assess the financial condition and risk profile of each final watch list bank.* Reserve Banks should review each final watch list bank in their Districts to assess the bank's financial condition and risk profile. Reserve Banks should consider recent examination findings for the bank and its affiliates, relevant information included in correspondence between the bank and the Reserve Bank, and other outside sources of information. Reserve Banks also should use all appropriate surveillance tools in evaluating each bank, including the Uniform Bank Performance Report, Bank

Holding Company Performance Reports, and results of the System Bank Monitoring Screens and the System BHC Monitoring Screens.

- *Determine whether the safety-and-soundness examination schedule should be accelerated for each watch list bank.* In cases where substantial deterioration in a bank's financial condition is evident or where a bank's risk profile has increased significantly, Reserve Banks should commence an on-site review of the bank no later than 60 days after the release of the final watch list. Unless an on-site examination has been completed within the last six months or the Reserve Bank can document that SR-SABR results do not reflect material safety-and-soundness concerns, Reserve Banks should generally accelerate examinations when a state member bank is assigned an SR-SABR rating of 1F, 2F, or 3F. The scope of on-site reviews conducted for watch list banks may vary, depending on the risk factors present and knowledge about the bank and its management. In some cases, discussing the issues with management may suffice; in others, a full-scope safety-and-soundness examination may be necessary.
- *Prepare surveillance write-ups for each watch list bank.* No more than 30 days after receiving the quarter's final watch list, Reserve Banks should document conclusions on the watch list banks in a write-up posted to the System's Central Data and Text Repository (CDTR) using the Banking Organization National Desktop (BOND) application.<sup>3</sup> Each write-up should be posted as a "State Member Bank Watch List Write-Up" and assigned an "as of" date that corresponds to the quarterly surveillance cycle. The write-ups should—
  - briefly summarize the cause for a bank's appearance on the watch list and assess whether it poses risks to the safety and soundness of the bank;

3. In general, Reserve Banks should create a separate quarterly watch list document for each state member bank included on the watch list. However, for bank subsidiaries of the largest banking organizations, which are subject to continuous supervision and already require separate quarterly written analyses, the factors required for a quarterly watch list write-up, if applicable, may be addressed within the standard quarterly documentation posted in the CDTR and BOND. Reserve Bank surveillance contacts, however, should notify the manager of the Surveillance, Financial Trends, and Analysis section of the specific CDTR documents that address these requirements.

- detail the supervisory actions that have been taken in response to safety-and-soundness concerns;
- describe bank management’s response to safety-and-soundness concerns;
- address whether the current CAMELS rating accurately reflects the bank’s condition, considering adverse SR-SABR results when applicable;
- assess whether the timing of the next safety-and-soundness examination should be accelerated; and
- describe the Reserve Bank’s plans for addressing any safety-and-soundness issues over the next quarter.

For state member banks that have been included on the watch list in the prior quarter, write-ups should focus on new developments or changes in the condition or performance of the bank. Key background information, however, should be carried forward so that the write-up serves as a stand-alone summary document of the bank’s current condition and prospects for improvement.

# Federal Reserve System Bank Watch List and Surveillance Programs

## Examination Objectives

Effective date November 2000

## Section 1020.2

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

# Federal Reserve System Bank Watch List and Surveillance Programs

## Examination Procedures

Effective date November 2000

## Section 1020.3

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

### INTRODUCTION

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

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

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

They also are useful as—

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

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

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

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

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

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

*Scope of Work*—This includes an indication of the nature, timing and extent of testing in application of examination and audit procedures. It also includes the examiner's evaluation of and reliance on internal and external audit

procedures and compliance testing of internal controls. To the extent that this information is contained in other workpapers, such as an examination procedure or a questionnaire, a reference to the appropriate workpaper will be sufficient.

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

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

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

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

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

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

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

- Condense information for simplicity.

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

## INITIAL PREPARATION BY OTHERS

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

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

Upon receipt of bank-prepared analyses, an examiner should review the documents for over-

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

## INITIAL APPROACH IN WORKPAPER PREPARATION

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

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

## CONTROL AND REVIEW

All examiners assigned to an examination should insure that workpapers are controlled at all times while the examination is in progress. For example, when in the bank's offices, the workpapers should be secured at night and safeguarded during the lunch hour or at other times when no examining personnel are present in the immediate vicinity. It is essential to completely control confidential information provided by the bank. In addition, information relating to the extent of tests and similar details of examination proce-

dures should not be made available to bank employees.

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

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

## REVIEW PROCEDURES

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

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

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

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

Professional judgment must be exercised throughout the review process.

## ORGANIZATION OF WORKPAPER FILES

Administration of an examination includes—

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

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

## FILES

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

- management appraisal.
- overall conclusions about the condition of the bank.
- cash accounts.
- investments.

- loans.
- reserve for possible loan losses.
- bank premises and equipment.
- other assets.
- deposits.
- other liabilities.
- capital accounts and dividends.

Each individual file would normally include—

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

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

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

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

## Indexing and Cross-Referencing

To promote efficiency and help ensure that all



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

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

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

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

## WORKPAPER RETENTION

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

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

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

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

### CASH

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

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

### CLEARINGS

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

Proof and transit were once two separate functions in a bank: the proving of work (proof) and the sending of out-of-town cash items (transit) for collection. Most banks have now combined these two functions. Proof and transit may be performed by any combination of tellers or proof clerks, a separate proof and transit depart-

ment, a check-processing department, an out-clearing department, or some other department that is characteristic of the area of the country where the bank operates. The functions may be centralized or decentralized, manual or automated, depending on the size of the bank and the volume of transactions. The volume of clearings may be so great that the bank's proof operations are conducted after time deadlines for transaction posting or courier delivery. In these cases, daily clearings customarily are determined as of a specific cutoff time. Checks processed to that time are carried in one day's totals, and checks processed after that time are carried in the following day's totals. However, no matter who performs the function or how large the bank, the objectives of a proof and transit system are the same:

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

### CASH ITEMS

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

In their normal daily operations, banks have an internal charge, on the general ledger, to total demand deposits not charged to individual accounts because of insufficient funds, computer misreads, or other problems. Commonly known as return items or rejected or unposted debits,

these items may consist of checks received in the ordinary course of business, loan-payment debits, and other debit memos. In some banks, return items are separated by the bookkeepers and an entry is made reclassifying them to a separate asset account entitled “bookkeepers’ return items.” Other banks do not use a separate asset account; instead, the bookkeepers include the items in a subsidiary control account in the individual demand deposit ledgers. In that case, the account would have a debit balance and would be credited when the bank processes items for posting or returns the checks to their source.

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

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

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

further collection effort.

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

## CURRENCY TRANSACTIONS

The reporting of currency and foreign transactions as covered in 31 CFR 1010 requires financial institutions to maintain records that might be useful in criminal, tax, or regulatory investigations. The regulation also seeks to identify persons who attempt to avoid payment of taxes through transfers of cash to or from foreign accounts. The examination procedures for determining compliance with the regulation require the examiner to ascertain the quality of the bank’s auditing procedures and operating standards relating to financial recordkeeping.<sup>1</sup> Examiners also determine the adequacy of written policies and bank training programs. The *Bank Secrecy Act/Anti-Money Laundering Examination Manual* is to be used in checking compliance and for reporting apparent violations in the reporting of currency and foreign transactions. Any violations noted should be listed with appropriate comments in the report of examination. Inadequate compliance could result in a cease-and-desist order to effect prompt compliance with the statute.

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

# Cash Accounts

## Examination Objectives

Effective date May 1996

## Section 2000.2

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

# Cash Accounts

## Examination Procedures

Effective date March 2011

## Section 2000.3

1. If selected for implementation, complete or update the cash accounts section of the internal control questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal or external auditors from the examiner assigned to that area of examination, and determine if appropriate corrections have been made.
4. Scan the general ledger cash accounts for any unusual items or abnormal fluctuations. Investigate any such items and document any apparent noncompliance with policies, practices and procedures for later review with appropriate management personnel.
5. Obtain teller settlement sheet recap or similar document as of the examination date and agree to the general ledger. Scan for reasonableness and conformity to bank policy.
6. Obtain detailed listings of cash items, including any bank items which are carried in the general ledger under "other assets," agree listings to general ledger balances and scan for propriety and conformity to bank policy.
7. Test compliance with Regulation H (12 CFR 208) by—
  - a. selecting teller and banking office cash-balance sheets and determining that balances are within currency limits established;
  - b. selecting bait money and agreeing serial numbers to applicable records;
  - c. reviewing documentation showing training sessions held since the preceding examination;
  - d. performing any visual inspections deemed appropriate;
  - e. analyzing the bank's system of security and protection against external crimes (Guidance for this analysis is provided in the internal control questionnaire in this section of the manual.); and
  - f. determining, through discreet corroborative inquiry of responsible bank officials and review of documentation, whether a security program that equals or exceeds the standards prescribed by Regulation H (12 CFR 208.61(c)) is in effect and that the annual compliance report and any other reports requested by the Federal Reserve System have been filed.
8. Review compliance with recordkeeping requirements and currency and foreign transaction reports. (See 31 CFR 1010.)
9. Review tellers' over and short accounts for recurring patterns and any large or unusual items and follow up as considered necessary. Investigate differences centered in any one teller or banking office. Determine whether corrective action has been taken, if required.
10. Determine, by discreet corroborative inquiry of responsible bank officials and review of documentation, whether defalcations and/or mysterious disappearances of cash since the preceding examination have been properly reported pursuant to current requirements of the Board of Governors.
11. Review foreign-currency control ledgers and dollar book value equivalents for the following:
  - a. accuracy of calculations and booking procedures
  - b. unusual fluctuations
  - c. concentrations
  - d. unusual items
12. Review international division revaluation calculations and procedures.
13. Review the following items with appropriate management personnel (or prepare a memo to other examining personnel for their use in reviewing with management):
  - a. internal-control exceptions and deficiencies in, or noncompliance with, written policies, practices and procedures
  - b. uncorrected audit deficiencies
  - c. violations of law
  - d. inaccurate booking of U.S. dollar book value equivalents for foreign currencies
  - e. inaccurate revaluation calculations and procedures performed by cash-account operations staff
14. Prepare comments on deficiencies or

- violations of law noted above for inclusion in the examination report.
15. Update the workpapers with any information that will facilitate future examinations.

# Cash Accounts

## Internal Control Questionnaire

Effective date March 2011

## Section 2000.4

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

### CASH ON HAND

- \*1. Do all tellers, including relief tellers, have sole access to their own cash supply, and are all spare keys kept under dual control?
- \*2. Do tellers have their own vault cubicle or controlled cash drawer in which to store their cash supply?
3. When a teller is leaving for vacation or for any other extended period of time, is that teller's total cash supply counted?
4. Is each teller's cash verified periodically on a surprise basis by an officer or other designated official (if so, is a record of such count retained)?
- \*5. Are cash drawers or teller cages provided with locking devices to protect the cash during periods of the teller's absence?
6. Is a specified limit in effect for each teller's cash?
- \*7. Is each teller's cash checked daily to an independent control from the proof or accounting control department?
8. Are teller differences cleared daily?
9. Is an individual, cumulative over and short record maintained for all persons handling cash, and is the record reviewed by management?
10. Does the teller prepare and sign a daily proof sheet detailing currency, coin, and cash items?
- \*11. Are large teller differences required to be reported to a responsible official for clearance?
12. Is there a policy against allowing teller "kitties"?
- \*13. Are teller transactions identified through use of a teller stamp?
- \*14. Are teller transfers made by tickets or blotter entries which are verified and initialed by both tellers?
15. Are maximum amounts established for tellers' cashing checks or allowing withdrawal from time deposit accounts without officer approval?
16. Does the currency at each location include a supply of bait money?
17. Are tellers provided with operational guidelines on check-cashing procedures and dollar limits?
18. Is a record maintained showing amounts and denominations of reserve cash?
- \*19. Is reserve cash under dual custody?
- \*20. Are currency shipments—
  - a. prepared and sent under dual control and
  - b. received and counted under dual control?
- \*21. If the bank uses teller machines—
  - a. is the master key controlled by someone independent of the teller function,
  - b. is the daily proof performed by someone other than the teller, and
  - c. are keys removed by the teller during any absence?
- \*22. Is dual control maintained over mail deposits?
23. Is the night depository box under a dual lock system?
24. Is the withdrawal of night deposits made under dual control?
25. Regarding night depository transactions—
  - a. are written contracts in effect;
  - b. are customers provided with lockable bags; and
  - c. are the following procedures completed with two employees present:
    - opening of the bags
    - initial recording of bag numbers, envelope numbers, and depositors' names in the register
    - counting and verification of the contents
- \*26. Regarding vault control—
  - a. is a register maintained which is signed by the individuals opening and closing the vault;
  - b. are time-clock settings checked by a second officer;
  - c. is the vault under dual control; and
  - d. are combinations changed periodically and every time there is a change in custodianship?

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

### CASH-DISPENSING MACHINES

- \*31. Is daily access to the automated teller machine (ATM) made under dual control?
- \*32. When maintenance is being performed on a machine, with or without cash in it, is a representative of the bank required to be in attendance?
- \*33. Are combinations and keys to the machines controlled (if so, indicate controls)?
34. Do the machines and the related system have built-in controls that—
- limit the amount of cash and number of times dispensed during a specified period (if so, indicate detail) and
  - capture the card if the wrong PIN (personal identification number) is consecutively used?
35. Does the machine automatically shut down after it experiences recurring errors?
36. Is lighting around the machine provided?
37. Does the machine capture cards of other banks or invalid cards?
38. If the machine is operated “off line,” does it have negative-file capability for present and future needs, which includes lists of lost, stolen, or other undesirable cards which should be captured?
39. Is use of an ATM by an individual customer in excess of that customer’s past history indicated on a Suspicious Activity Report (SAR) by depository institutions to be checked out by bank management (for example, three uses during past three days as compared with a history of one use per month)?
40. Have safeguards been implemented at the ATM to prevent, during use, the disclosure of a customer’s PIN by others observing the PIN pad?
41. Are “fish-proof” receptacles provided for customers to dispose of printed receipts, rather than insecure trash cans, etc.?
42. Does a communication interruption between

- an ATM and the central processing unit trigger the alarm system?
43. Are alarm devices connected to all automated teller machines?
44. For on-line operations, are all messages to and from the central processing unit and the ATM protected from tapping, message insertion, modification of message or surveillance by message encryption (scrambling techniques)? (One recognized encryption formula is the National Bureau of Standards Algorithm.)
- \*45. Are PINs mailed separately from cards?
- \*46. Are bank personnel who have custody of cards prohibited from also having custody of PINs at any stage (issuance, verification, or reissuance)?
47. Are magnetic stripe cards encrypted (scrambled) using an adequate algorithm (formula) including a total message control?
48. Are encryption keys, i.e., scramble plugs, under dual control of personnel not associated with operations or card issuance?
- \*49. Are captured cards under dual control of persons not associated with bank operation card issuance or PIN issuance?
- \*50. Are blank plastics and magnetic stripe readers under dual control?
51. Are all cards issued with set expiration dates?
52. Are transaction journals provided that enable management to determine every transaction or attempted transaction at the ATM?

### CASH ITEMS

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



57. Do the bank's present procedures forbid the holding of overdraft checks in the cash-item account?
58. Are all cash items reviewed at least monthly at an appropriate level of management?
- \*59. Are cash items recommended for charge-off reviewed and approved by the board of directors, a designated committee thereof, or an officer with no operational responsibilities?
- this section and are clearing on a timely basis,
- \*c. scrutinized for employee items, and
- d. reviewed for large or repeat items?
67. Are holdover items—
- a. appropriately identified in the general ledger,
- \*b. handled by an independent section of the department, and
- c. reviewed periodically by responsible supervisory personnel to determine that items are clearing on a timely basis?

## PROOF AND TRANSIT

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

## REGULATION H (12 CFR 208)— COMPLIANCE QUESTIONNAIRE

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

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

### 31 CFR 1010—COMPLIANCE QUESTIONNAIRE

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

### INTERNATIONAL DIVISION

- \*79. Are foreign-currency control ledgers and dollar-book-value equivalents posted accurately?
- \*80. Is each foreign currency revalued at least monthly, and are profit and loss entries passed on to the appropriate income accounts?
- \*81. Are revaluation calculations, including the rates used, periodically reviewed for accu-

racy by someone other than the foreign-currency tellers?

- \*82. Does the internal auditor periodically review for accuracy revaluation calculations, including the verification of rates used and the resulting general ledger entries?

### CONCLUSION

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

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

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

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

## DEPOSITS WITH OTHER DEPOSITORY INSTITUTIONS

Section 206.3 of Regulation F (12 CFR 206) requires FDIC-insured depository institutions to adopt written policies and procedures to address the risk arising from exposure to a correspondent, and to prevent excessive exposure to any individual correspondent. These policies and procedures should take into account the financial condition of a correspondent and the size,

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

form, and maturity of the exposure. Section 206.4(a) of Regulation F stipulates that any FDIC-insured depository institution must limit its interday credit exposure to an individual correspondent that is not “adequately capitalized”<sup>2</sup> to 25 percent of the institution’s total capital.<sup>3</sup> For a more detailed discussion of Regulation F, refer to sections 2015.1–4 and SR-93-36 (“Examiner Guidelines for Regulation F—Interbank Liabilities”).

## BALANCES WITH FEDERAL RESERVE BANKS

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

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

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

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

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

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

## DEPOSIT BROKERS

On the asset side of the balance sheet, examiners should review the activities of banks that place deposits through money brokers. These banks should have sufficient documentation to, among other things, verify the amounts and terms of individual deposits and the names of depository institutions in which the deposits are placed. Banks should also be able to demonstrate that they have exercised appropriate credit judgment with respect to each depository institution in which they have placed funds. Deficiencies in this area could constitute an unsafe or unsound banking practice. A more detailed discussion of brokered deposits is included in "Deposit Accounts," sections 3000.1–3000.3 of this manual.

## DUE FROM FOREIGN BANKS

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

A bank must be prepared to make and receive payments in foreign currencies to meet the needs

of its international customers. This can be accomplished by maintaining accounts (nostro balances) with banks in foreign countries in whose currencies receipts and payments are made.

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

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

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

In addition, an account service known as a payable-through account is being marketed by U.S. banks, Edge corporations, and the U.S. branches and agencies of foreign banks to foreign banks that otherwise would not have the ability to offer their customers access to the U.S. banking system. This account service, referred to by other names such as pass-through accounts and pass-by accounts, involves a U.S. banking entity's opening of a deposit account for the foreign bank. Policies and procedures should be

developed to guard against the possible improper or illegal use of payable-through account facilities by foreign banks and their customers.

Examination procedures relating to this area are part of the *FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual*.

# Due from Banks

## Examination Objectives

Effective date May 1996

## Section 2010.2

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

# Due From Banks

## Examination Procedures

Effective date May 2007

## Section 2010.3

1. If selected for implementation, complete or update the Due From Banks Internal Control Questionnaire.
2. Determine the scope of the examination, based on the evaluation of internal controls and the work performed by internal/external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned “Internal Control,” and determine if corrections have been accomplished.
4. Scan the most recent bank-prepared reconcilements for any unusual items and determine that closing balances listed on reconcilements agree with the general ledger and with the balance shown on the cut-off statement if one has been obtained.
5. If the bank’s policy for charge-off of old open items provides for exceptions in extenuating circumstances, review excepted items and determine if charge-off is appropriate.
6. If the bank has no policy for charge-off of old open items, review any items which are large or unusual or which have been outstanding for over two months, along with related correspondence, and determine if charge-off is appropriate.
7. Test the bank’s calculation of its Federal Reserve requirement and determine that reports are accurate and complete by:
  - a. Performing a limited review of a sample of line items if the bank has effective operating procedures and has an audit program covering the required reports.
  - b. Performing a detailed review of all line items if the bank has not established operating procedures or does not have an audit program covering the required reports.
8. Confer with the examiner assigned to check for compliance with the laws and regulations relating to insider loans at correspondent banks and loans to insiders of correspondent banks (Regulation O and 12 USC 1972(2)) and either provide a list, or verify a bank supplied list, of correspondent banks. (This effort should be coordinated with the examiner assigned to “Deposit Accounts” to avoid duplication of work.)
9. Review the maximum deposit balance established for each due from bank account and determine if the maximum balance:
  - a. Is established after consideration of compensating balance requirements resulting from commitments or credit lines made available to the bank or its holding company. Coordinate this effort with examiner assigned “Bank-Related Organizations.”
  - b. Appears to be related to loans of executive officers or directors or to loans which have been used to acquire stock control of the bank under examination.
    - If such due from accounts are detected, provide full details of the account to the examiner assigned to check for compliance with the law relating to loans to insiders of correspondent banks (12 USC 1972(2)).
10. Determine the existence of any concentrations of assets with other banks. Include correspondent accounts, time deposits and any federal funds sold in computation. For concentrations exceeding 25 percent of the bank’s capital structure, forward the information to examiners assigned “Concentrations of Credit” for possible inclusion in the report of examination.

*Note:* Procedures 11 through 21 apply to due from foreign banks—demand (nostro accounts).
11. Obtain or prepare a trial balance (including local currency book values) of due from foreign banks—demand by bank customer and:
  - a. Agree or reconcile balances to department controls and the general ledger.
  - b. Review reconciling items for reasonableness.
12. Using the appropriate sampling technique, select demand account banks for examination.
13. Prepare credit line sheets to include:
  - a. Customer’s aggregate due from banks—demand liability in foreign currency

- amount and local currency equivalent.
- b. Amount of customer's line designated by the bank.
  - c. Frequency of recent overdrawn nostro accounts.
- (Overdrawn nostro accounts as they relate to foreign exchange activities are discussed in the International—Foreign Exchange section. Also, the examiner assigned “Borrowed Funds” must obtain (or prepare) a listing of overdrawn nostro accounts for inclusion in the borrowing section of the report of examination.)
- d. Past compliance with customer's line limitation as determined from review of liability ledger records.
14. Obtain from the examiner assigned “International—Loan Portfolio Management,” schedules on the following, if they are applicable to the due from foreign banks—demand:
    - a. Delinquencies.
    - b. Miscellaneous loan debit and credit suspense accounts.
    - c. Criticized shared national credits.
    - d. Interagency Country Exposure Review Committee credits.
    - e. Loans criticized during the previous examination.
    - f. Information on directors, officers and their interests, as contained in statements required under Regulation O (12 CFR 215).
    - g. Specific guidelines in the bank policy relating to due from banks—demand.
    - h. Current listing of due from foreign banks—demand approved customer lines.
    - i. Any useful information resulting from the review of the minutes of the loan and discount committee or any similar committee.
    - j. Reports furnished to the board of directors.
  15. Review the information received and perform the following for:
    - a. Miscellaneous loan debit and credit suspense accounts:
      - Discuss with management any large or old items.
      - Perform additional procedures as deemed appropriate.
    - b. Interagency Country Exposure Review Committee Credits:
      - Compare the schedule to the trial balance to determine which due from foreign banks—demand deposits are portions of Interagency Country Exposure Review Committee credits.
      - For each due from foreign bank—demand deposit so identified, transcribe appropriate information to line sheets and forward the information to the examiner assigned “International—Loan Portfolio Management.”
    - c. Loans criticized during the previous examination (due from foreign banks—demand portion):
      - Determine the disposition of the due from foreign banks—demand so criticized by transcribing:
        - Current balance and payment status, or
        - Date the deposit was paid and the source of repayment.
  16. Transcribe or compare information from the above schedules to credit line sheets, where appropriate, and indicate any cancelled bank lines.
  17. Prepare credit line cards for any due from foreign banks—demand not in the sample which, based on information derived from the above schedules, requires in-depth review.
  18. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts and loan areas and together decide who will review the borrowing relationship. Pass or retain completed credit line cards.
  19. Obtain credit files for all due from foreign banks—demand for whom credit line cards were prepared and complete credit line cards where appropriate. To analyze the loans, perform the procedures set forth in step 14 of the International—Due From Banks—Time section.
  20. By reviewing appropriate bank records, determine that:
    - a. Profit or losses resulting from revaluation adjustment on net open positions spot are passed properly to the respective due from foreign bank—demand (nostro) account (usually monthly).
    - b. At the delivery of the “swap” forward contract, proper entries are made to the respective due from foreign bank—demand (nostro) and swap adjustment accounts.



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

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

# Due From Banks

## Internal Control Questionnaire

Effective date March 1984

## Section 2010.4

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

### POLICIES FOR DUE FROM BANK DOMESTIC AND FOREIGN— DEMAND ACCOUNTS

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

### BANK RECONCILEMENTS

3. Are bank reconcilements prepared promptly upon receipt of the statements?
- \*4. Are bank statements examined for any sign of alteration and are payments or paid drafts compared with such statements by the persons who prepare bank reconcilements (if so, skip question 5)?
- \*5. If the answer to question 4 is no, are bank statements and paid drafts or payments handled before reconciliation only by persons who do not also:
  - a. Issue drafts or official checks and prepare, add or post the general or subsidiary ledgers?
  - b. Handle cash and prepare, add or post the general ledger or subsidiary ledgers?
- \*6. Are bank reconcilements prepared by persons who do not also:
  - a. Issue drafts or official checks?
  - b. Handle cash?
  - c. Prepare general ledger entries?
7. Concerning bank reconcilements:
  - a. Are amounts of paid drafts or repayments compared or tested to entries on the ledgers?
  - b. Are entries or paid drafts examined or reviewed for any unusual features?
  - c. Whenever a delay occurs in the clearance of deposits in transit, outstanding drafts and other reconciling items, are such delays investigated?
  - d. Is a record maintained after an item has cleared regarding the follow-up and reason for any delay?
  - e. Are follow-up and necessary adjusting entries directed to the department originating or responsible for the entry for correction with subsequent review of the resulting entries by the person responsible for reconciliation?
  - f. Is a permanent record of the account reconciliation maintained?
  - g. Are records of the account reconcilements safeguarded against alteration?
  - h. Are all reconciling items clearly described and dated?
  - i. Are details of account reconciliation reviewed and approved by an officer or supervisory employee?
  - j. Does the person performing reconcilements sign and date them?
  - k. Are reconciliation duties for foreign

demand accounts rotated on a formal basis?

## DRAFTS

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

## FOREIGN CASH LETTERS

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

## FOREIGN RETURN ITEMS

10. Are there procedures for the handling of return items so that:

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

## FOREIGN EXCHANGE ACTIVITIES

- \*11. Are persons handling and reconciling due from foreign bank—demand accounts excluded from performing foreign exchange and position clerk functions?
- \*12. Is there a daily report of settlements made and other receipts and payments of foreign currency affecting the due from foreign bank—demand accounts?
- \*13. Is each due from foreign bank—demand foreign currency ledger revalued monthly and are appropriate profit or loss entries passed to applicable subsidiary ledgers and the general ledger?
- \*14. Does an officer not preparing the calculations review revaluations of due from foreign bank—demand ledgers, including the verification of rates used and the resulting general ledger entries?

## OTHER—FOREIGN

- \*15. Are separate dual currency general ledger or individual subsidiary accounts maintained for each due from foreign bank—demand account, indicating the foreign currency balance and a U.S. dollar (or local currency) equivalent balance?
- 16. Do the above ledger or individual subsidiary accounts clearly reflect entry and value dates?
- 17. Are the above ledger or individual subsidiary accounts balanced to the general ledger on a daily basis?
- 18. Does international division management receive a daily trial balance of due from foreign bank—demand customer balances by foreign currency and U.S. dollar (or local currency) equivalents?

**OTHER**

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

It is important for a federally insured depository institution<sup>1</sup> (bank) to control and limit the risk exposures posed to it by another domestic bank (whether or not that institution is an insured depository institution) or foreign bank with which it does business (referred to as a *correspondent*). These exposures may include all extensions of credit to a correspondent; deposits or reverse repurchase agreements with a correspondent; guarantees, acceptances, or standby letters of credit on behalf of a correspondent; purchases or acceptance as collateral of correspondent-issued securities; and all similar transactions. A bank needs to develop internal procedures to evaluate and control the risk exposures to the bank from its correspondents. Such procedures would help prevent a situation whereby the failure of a single correspondent could trigger the failure of a federally insured depository institution having claims on the failed correspondent. (See SR-93-36.)

A bank's principal sources of exposure to its correspondent tend to arise from two types of activity. First, banks may become exposed when obtaining services from (such as check-collection services), or providing services to, their correspondents. Second, exposure may arise when banks engage in transactions with correspondents in the financial markets. Each type of exposure has its own characteristics and its own risks.

Correspondent banking services are the primary source of interbank exposure for the majority of banks, particularly small and medium-sized banks. In connection with check-collection services and other trade- or payment-related correspondent services, banks often maintain balances with their correspondents in order to settle transactions and compensate the correspondents for the services provided. These balances give rise to exposure to the correspondents. Although correspondent services are in some cases provided on a fee basis, many correspondents may prefer compensating-balance arrangements, as these balances provide the correspondents with a stable source of funding. Also, some banks may prefer to pay for services with

“soft charges” in the form of balances instead of “hard charges” in the form of fees.

Exposure to a correspondent may be significant, particularly when a bank uses one correspondent for all of its check collections and other payment services; loans excess reserve account balances (federal, or fed, funds) to the correspondent,<sup>2</sup> or engages in other banking transactions with correspondents.<sup>3</sup> This exposure may increase when interest rates fall, as higher levels of compensating balances may be required to provide adequate compensation to the correspondent.

Money-center banks and large regional banks may have significant exposure to correspondents<sup>4</sup> through their activities in interbank markets, such as the securities, swap, and foreign-exchange markets. Interbank transactions that call for performance in the future (such as swaps, foreign-exchange contracts, and over-the-counter options) give rise to exposure to the correspondents that act as counterparties<sup>5</sup> in such transactions. In addition to credit risk, such transactions may involve interest-rate risk,

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2. In the fed funds market, a loan of fed funds is often referred to as a sale. Borrowing of fed funds is referred to as a purchase.

3. Although a bank's primary correspondent often will borrow (purchase) fed funds as principal directly from the bank, a correspondent may act as agent to place the funds with another institution. In such agency arrangements, a bank may provide its correspondent with a preapproved list of institutions with which the correspondent may place the funds. When a correspondent is acting as the bank's agent in placing fed funds, the bank's exposure would be to the ultimate purchaser of the funds, not to the correspondent placing the funds on its behalf.

Generally, fed funds loans are unsecured. A bank may also provide funds to a correspondent through transactions known as *reverse repurchase agreements*, in which the bank provides funds to the correspondent by buying an asset, generally a government security. The correspondent agrees that it will repurchase the asset from the bank at the expiration of a set period, generally overnight, at a repurchase price calculated to compensate the bank for the use of its funds. Unlike fed funds loans, these transactions are essentially secured transactions.

4. Although the depository institutions that are parties to transactions in the interbank markets discussed above generally are referred to as *counterparties*, the term *correspondent* is used in this discussion to denote any domestic depository institution or a foreign bank to which a bank is exposed. The term *correspondent* does not include a commonly controlled correspondent, as defined in section 206.2(b) of Regulation F.

5. In other banking transactions, such as foreign-exchange, money market, and other permissible transactions, activities, or contractual arrangements, the other party to the transaction is referred to as the counterparty rather than as the correspondent.

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1. A federally insured depository institution refers to a bank, as defined in section 3 of the Federal Deposit Insurance Act (12 USC 1813), and includes a federally insured national bank, state bank, District bank, or savings association, and a federally insured branch of a foreign bank.

foreign-exchange risk, and settlement risk. Settlement risk is the risk that a counterparty will fail to make a payment or delivery in a timely manner. Settlement risk may arise from unsecured transactions in the government securities, foreign-exchange, or other markets, and it may result from operational, liquidity, or credit problems.

Lending limits prohibit national banks from lending amounts equal to more than 15 percent of a national bank's unimpaired capital and surplus to a single borrower on an unsecured basis (12 USC 84(a)(1)); these limits also prohibit a national bank from lending an additional 10 percent on a secured basis (12 USC 84(a)(2)). The national bank lending limits apply only to "loans and extensions of credit," and the limits do not include most off-balance-sheet transactions that may provide significant sources of exposure to correspondents. Additionally, the national bank lending limits do not apply to overnight fed funds loans, a significant source of short-term exposure to correspondents. State limits generally do not apply to a broader range of transactions than the national bank limits, although some states include fed funds transactions within their limits.

State-chartered banks generally are subject to lending limits under state law. Almost all states impose lending limits on the banks they charter. Most of these limits are patterned on the national bank lending limits, although the specific percentages or transactions covered vary. The state limits generally do not apply to a broader range of off-balance-sheet transactions, although some states include fed funds transactions within their limits. A number of states, however, exclude interbank transactions from their lending limits entirely.

## LIMITS ON INTERBANK LIABILITIES

Regulation F, Limitations on Interbank Liabilities (12 CFR 206), implemented section 308 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which amended section 23 of the Federal Reserve Act (12 USC 371b-2). Section 23, as amended, requires the Board of Governors of the Federal Reserve System (the Board) to prescribe standards to limit the risks posed by exposure of banks to other domestic depository institutions

and foreign banks. Regulation F sets forth these standards. All depository institutions insured by the FDIC are subject to the Federal Reserve Board's Regulation F.<sup>6</sup> Regulation F was first adopted in 1992 and has remained substantially the same, except for the technical amendments adopted by the Board on September 10, 2003. (See 68 *Fed. Reg.* 53,283.) Regulation F consists of two primary parts: (1) prudential standards that apply to exposures generally (section 206.3) and (2) special rules that apply to credit exposure under certain circumstances (section 206.4).

The "Prudential Standards" section requires depository institutions to develop and adopt internal policies and procedures to evaluate and control all types of exposures to correspondents with which they do business.<sup>7</sup> Policies and procedures are to be established and maintained to prevent excessive exposure to any individual correspondent in relation to the condition of the correspondent. The "Prudential Standards" section requires a bank to adopt internal exposure limits when the financial condition of the correspondent and the form or maturity of the exposure create a significant risk that payments will not be made in full or on time. This section also provides that a bank shall structure the transactions of a correspondent or monitor exposures to a correspondent such that the bank's exposure ordinarily does not exceed its internal limits.

The "Credit Exposure" section provides that a bank's internal limit on interday *credit exposure* to an individual correspondent may not be more than 25 percent of the exposed bank's total capital, unless the bank can demonstrate that its correspondent is at least "adequately capitalized," as defined in section 206.5(a) of the rule. No limit is specified for credit exposure to correspondents that are at least adequately capitalized, but prudential standards are required for all correspondents, regardless of capital level. The term *correspondent* includes both domestically chartered depository institutions that are FDIC insured and foreign banks; the term does not include a commonly controlled correspondent.

6. Correspondent is defined in section 206.2(c) of Regulation F to mean a U.S. depository institution or a foreign bank to which a bank has exposure, but does not include commonly controlled correspondents.

7. Banks had to have the internal policies and procedures in place on June 19, 1993.

## Prudential Standards

### *Standards for Selecting Correspondents*

Banks are to address the risk arising from exposure to a correspondent, taking into account the financial condition of the correspondent and the size, form, and maturity of its exposure to the correspondent. Banks must adopt internal policies and procedures that evaluate the credit and liquidity risks, including operational risks, in selecting correspondents and terminating those relationships. Depository institutions are permitted to adopt flexible policies and procedures in order to permit resources to be allocated in a manner that will result in real reductions in risk. The policies and procedures must be reviewed annually by the bank's board of directors, but individual correspondent relationships need not be approved by the board. Examiners should determine that the policies and procedures adopted by the board provide for a determination of the credit, liquidity, and operational risks of a correspondent when the relationship with the correspondent is established and as it is maintained.<sup>8</sup> Additionally, if the bank has significant operational risk—such as relying on a correspondent for extensive data processing—that exposure could also lead to liquidity problems. This exposure may not be an issue for institutions that are not operationally dependent on any particular correspondent. Many banks may also address this exposure elsewhere in their operational procedures.

A bank's policies and procedures should provide for periodic review of the financial condition of any correspondent to which the bank has significant exposure. This review should evaluate whether the size and maturity of the exposure is commensurate with the correspondent's

financial condition.<sup>9</sup> Factors bearing on the financial condition of the correspondent include, but are not necessarily limited to, (1) the capital level of the correspondent, (2) the level of nonaccrual and past-due loans and leases, and (3) the level of earnings.

Examiners should determine that a bank has periodically reviewed the financial condition of any correspondent to which the bank has significant exposure. The frequency of these reviews will depend on the size and maturity of the exposure and the condition of the correspondent. For example, the policies of many banks provide for an extensive annual review of a correspondent's financial condition; such policies may also provide for less extensive interim reviews under some circumstances, such as when exposure to a correspondent is very high or when a correspondent has experienced financial difficulty. A bank need not require periodic review of the financial condition of all correspondents. For example, periodic reviews would not be necessary for a correspondent to which the bank has only insignificant levels of exposure, such as small balances maintained for clearing purposes.<sup>10</sup> Significant levels of exposure should reflect those amounts that a prudent bank believes deserve analysis for risk of loss.

A bank may base its review of the financial condition of a correspondent on publicly available information, such as bank Call Reports, financial statements or reports, Uniform Bank Performance Reports, or annual reports, or the bank may use financial information obtained from a rating service. A bank generally is not required to obtain nonpublic information to use as the basis for its analysis and review of the financial condition of a correspondent.<sup>11</sup> For

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8. *Liquidity risk* and *operational risk* are terms used in the definition of exposure. Liquidity risk is the risk that payment will be delayed for some period of time. For example, a bank is subject to the liquidity risk that a payment due from a failed correspondent will not be made on time; the bank's credit risk may be a lesser amount due to later distributions from the correspondent's receiver. Liquidity risk is included in the definition of exposure.

Operational risk is the risk that a correspondent's operational problems may prevent it from making payments, thereby creating liquidity risks for other banks. For example, a computer failure at a correspondent that a bank relies on for extensive data processing support may prevent the correspondent from making payments, and thus may create liquidity problems for the bank and other banks as well. Operational risk is also included in the definition of exposure.

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9. Because exposure to a Federal Reserve Bank or Federal Home Loan Bank poses minimal risk to a respondent, Federal Reserve Banks and Federal Home Loan Banks are not included in the definition of correspondent.

10. Other forms of exposure that generally would not be considered significant include (1) a collecting bank's risk that a check will be returned, (2) an originating bank's risk that an automated clearinghouse (ACH) debit transfer will be returned or its settlement reversed, (3) a receiving bank's remote risk that settlement for an automated credit transfer could be reversed, or (4) a credit card transaction. In these types of transactions, the amounts involved are generally small, and the exposed bank usually has prompt recourse to other parties.

11. A bank *is* required to obtain nonpublic information to evaluate a correspondent's condition for those foreign banks for which no public financial statements are available. In these limited circumstances, the bank would need to obtain financial information for its review (including information obtained directly from the correspondent).

correspondents with which a bank has a significant relationship, a bank may have considerable nonpublic information, such as information on the quality of management, general portfolio composition, and similar information, but such information is not always available and is not required.

Regardless of whether public or nonpublic sources of information are used, a bank may rely on another party, such as a bank rating agency, its bank holding company, or another correspondent, to assess the financial condition of or select a correspondent, provided that the board of directors has reviewed and approved the general assessment or selection criteria used by that party. Examiners should ascertain that the bank reviews and approves the assessment criteria used by such other parties. Additionally, when a bank relies on its bank holding company to select and monitor correspondents—or relies on a correspondent, such as a bankers' bank, to choose other correspondents with which to place the bank's federal funds or other deposits—examiners should ensure that the bank has reviewed and approved the selection criteria used.

### *Internal Limits on Exposure*

When the financial condition of the correspondent and the form or maturity of the exposure represent a significant risk that payments will not be made in full or in a timely manner, a bank's policies and procedures must limit its exposure to the correspondent, either by the establishment of internal limits or by other means. Limits are to be consistent with the risks undertaken, considering the financial condition and the form and maturity of the exposure to the correspondent. Limits may specify fixed exposure amounts, or they may be more flexible and be based on factors such as the monitoring of exposure and the financial condition of the correspondent. Different limits may be set for different forms of exposure, different products, and different maturities.

When a bank has exposure to a correspondent that has a deteriorating financial condition, examiners should determine if the bank took that deterioration into account when it evaluated the correspondent's creditworthiness. The examiner should also evaluate if the bank's level of exposure to the correspondent was appropriate.

Examiners need to determine that the bank's

policy and procedural limits are consistent with the risk undertaken, given the maturity of the exposure and the condition of the correspondent. Inflexible dollar limits may not be necessary in all cases. As stated earlier, limits can be flexible and be based on factors such as the level of the bank's monitoring of its exposure and the condition of the correspondent. For example, a bank may choose not to establish a specific limit on exposure to a correspondent when the bank is able to ascertain account balances with the correspondent on a daily basis, because such balances could be reduced rapidly if necessary. In appropriate circumstances, a bank may establish limits for longer-term exposure to a correspondent, while not setting limits for interday (overnight) or intraday (within the day) exposure. Generally, banks do not need to set one overall limit on their exposure to a correspondent. Banks may prefer instead to set separate limits for different forms of exposure, products, or maturities. A bank's evaluation of its overall facility with a correspondent should take into account utilization levels and procedures for further limiting or monitoring overall exposure.

When a bank has established internal limits for its significant exposure, examiners should ensure that the bank either (1) has procedures to monitor its exposure to remain within established limits or (2) structures transactions with the correspondent to ensure that the exposure ordinarily remains within the bank's established internal limits. While some banks may monitor actual overall exposure, others may establish individual lines for significant sources of exposure, such as federal funds sales. For such banks, the examiner should ensure that the bank has established procedures to ensure that exposure generally remains within the established lines. In some instances, a bank may accomplish this objective by establishing limits on exposure that are monitored by a correspondent, such as for sales of federal funds through the correspondent as agent.

When a bank monitors its exposures, the appropriate level of monitoring will depend on (1) the type and volatility of the exposure, (2) the extent to which the exposure approaches the bank's internal limits for the correspondent, and (3) the condition of the correspondent. Generally, monitoring may be conducted retrospectively. Examples of retrospective monitoring include checking close-of-business balances at a correspondent for the prior day or obtaining daily balance records from a correspondent at



the end of each month. Thus, banks are not expected to monitor exposure to correspondents on a real-time basis.

The purpose of requiring banks to monitor or structure their transactions that are subject to limits is to ensure that the bank's exposure generally remains within established limits. However, occasional excesses over limits may result from factors such as unusual market disturbances, unusual favorable market moves, or other unusual increases in activity or operational problems. Unusual late incoming wires or unusually large foreign cash letters (international pouch) would be considered examples of activities that could lead to excesses over internal limits and that would not be considered impermissible under the rule. Examiners should verify that banks have established appropriate procedures to address any excesses over internal limits.

A bank's internal policies and procedures must address intraday exposure. However, as with other exposure of longer maturities (i.e., interday or longer), the rule does not necessarily require that limits be established on intraday exposure. Examiners should expect to see such limits or frequent monitoring of balances only if the size of the intraday exposure and the condition of the correspondent indicate a significant risk that payments will not be made as contemplated. Examiners should keep in mind that intraday exposure may be difficult for a bank to actively monitor and limit. Consequently, like interday exposure, intraday exposure may be monitored retrospectively. In addition, smaller banks may limit their focus on intraday exposure to being aware of the range of peak intraday exposure to particular institutions and the effect that exposure may have on the bank. For example, a bank may receive reports on intraday balances from a correspondent on a monthly basis and would only need to take actions to limit or more actively monitor such exposure if the bank becomes concerned about the size of the intraday exposure relative to the condition of the correspondent.

## Credit Exposure

A bank's internal policies and procedures must limit overnight credit exposure to an individual correspondent to not more than 25 percent of the exposed bank's total capital, unless the bank can

demonstrate that its correspondent is at least adequately capitalized.<sup>12</sup> The credit exposure of a bank to a correspondent shall consist of the bank's assets and off-balance-sheet items that are (1) subject to capital requirements under the capital adequacy guidelines of the bank's primary federal supervisor and (2) involve claims on the correspondent or capital instruments issued by the correspondent.<sup>13</sup> Credit exposure therefore includes items such as deposit balances with a correspondent, fed funds sales, and credit-equivalent amounts of interest-rate and foreign-exchange-rate contracts and other off-balance-sheet transactions. Credit exposure does not include settlement of transactions, transactions conducted in an agency or similar capacity where losses will be passed back to the principal or other party, and other sources of exposure that are not covered by the capital adequacy guidelines or that do not involve exposure to a correspondent.<sup>14</sup> A bank may exclude the following from the calculation of credit exposure to a correspondent: (1) transactions, including reverse repurchase agreements, to the extent that the transactions are secured by government securities or readily marketable collateral; (2) the proceeds of checks and other cash items depos-

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12. Total capital is the total of a bank's tier 1 and tier 2 capital calculated according to the risk-based capital guidelines of the bank's primary federal supervisor. For an insured branch of a foreign bank organized under the laws of a country that subscribes to the principles of the Basel Capital Accord, *total capital* means total tier 1 and tier 2 capital as calculated under the standards of that country. For an insured branch of a foreign bank organized under the laws of a country that does not subscribe to the principles of the Basel Capital Accord, *total capital* means total tier 1 and tier 2 capital as calculated under the provisions of the accord. The limit on credit exposure of the insured branch of a foreign bank is based on the foreign bank's total capital, as defined in this section, not on the imputed capital of the branch.

For purposes of Regulation F, an adequately capitalized correspondent is a correspondent with a total risk-based capital ratio of 8.0 percent or greater, a tier 1 risk-based capital ratio of 4.0 percent or greater, and a leverage ratio of 4.0 percent or greater. The leverage ratio does not apply to correspondents that are foreign banks. See section 206.5(e) for definitions of these terms.

13. A bank is required to include with its own credit exposure 100 percent of the credit exposure of any subsidiary that the bank is required to consolidate on its bank Call Report. This provision generally captures the credit exposure of any majority-owned subsidiary of the bank. Therefore, none of a minority-owned subsidiary's exposure and all of a majority-owned subsidiary's exposure would be included in the parent bank's exposure calculation.

14. For example, when assets of a bank, such as securities, are held in safekeeping by a correspondent, there is no exposure to the correspondent, even though the securities themselves may be subject to a capital charge.

ited in an account at a correspondent that are not yet available for withdrawal, (3) quality assets on which the correspondent is secondarily liable, or obligations of the correspondent on which a creditworthy obligor in addition to the correspondent is available; (4) exposure that results from the merger with or acquisition of another bank for one year after that merger or acquisition is consummated; and (5) the portion of the bank's exposure to the correspondent that is covered by federal deposit insurance. (See section 206.4(d) for a more detailed discussion of these exclusions.) This regulatory limit on credit exposure should be implemented as part of the bank's policies and procedures required under the "Prudential Standards" section. Regulation F does not impose regulatory limits for "credit exposure" to adequately or well-capitalized correspondents.

Quarterly monitoring of capital is only required for correspondents to which a bank's potential credit exposure is more than 25 percent of its total capital.<sup>15</sup> If the internal systems of a bank ordinarily limit credit exposure to a correspondent to 25 percent or less of the exposed bank's total capital, no monitoring of the correspondent's capital would be necessary, although periodic reviews of the correspondent's financial condition may be required under the "Prudential Standards" section if exposure to the correspondent is significant. Every effort should be made to allow banks to use existing risk-monitoring and -control systems and practices when these systems and practices effectively maintain credit exposure within the prescribed limits. For smaller institutions, it is relatively easy to determine how their measure of exposure compares with the definition of credit exposure in Regulation F because these institutions have relatively simple types of exposure. Examiners should remember that the regulation emphasizes appropriate levels of exposure based on the exposed bank's analysis of the credit-worthiness of its correspondents. Accordingly, for those correspondents that the bank has not demonstrated are at least adequately capitalized, this limit should be viewed as a maximum

credit-exposure level rather than as a safe-harbor level of credit exposure.

Examiners should ensure that the bank has in place policies and procedures that ensure the quarterly monitoring of the capital of its domestic correspondents. This quarterly schedule allows the bank to pick up information from the correspondent's most recent bank Call Report, financial statement, or bank rating report. Currently, it is difficult to obtain information on the risk-based capital levels of a correspondent. Regulation F requires that a bank must be able to demonstrate only that its correspondent's capital ratios qualify it as at least adequately capitalized.

A bank is not limited to a single source of information for capital ratios. A bank may rely on capital information obtained from a correspondent, a bank rating agency, or another reliable source of information. Further, examiners should anticipate that most banks will receive information on their correspondent's capital ratios either directly from the correspondents or from a bank rating agency. The standard used in the rule is based solely on capital ratios and does not require disclosure of CAMELS ratings. For foreign bank correspondents, monitoring frequency should be related to the frequency with which financial statements or other regular reports are available. Although such information is available quarterly for some foreign banks, financial statements for many foreign banks are generally available only on a semiannual basis.

Information on risk-based capital ratios may not be available for many foreign bank correspondents. As with domestic correspondents, however, examiners should anticipate that in most instances the correspondent will provide the information to the banks with which it does business.

A bank's internal policies and procedures should limit overnight credit exposure to a correspondent to not more than 25 percent of the exposed bank's total capital, unless the bank can demonstrate that its correspondent is at least adequately capitalized, as defined by the rule. However, examiners should not necessarily expect banks to have formal limits on credit exposure to a correspondent for which the bank does not maintain quarterly capital information or that is a less than adequately capitalized correspondent if the banks' policies and procedures effectively limit credit exposure to an amount below the 25 percent limit of total capital. Such situations include those in which

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15. Because information on risk-based capital ratios for banks is generally based on the bank Call Report, a bank would be justified in relying on the most recently available reports based on Call Report data. While there may be a significant lag in such data, Call Reports are useful for monitoring trends in the condition of a correspondent—especially when a bank follows the data on a continuing basis.

only small balances are maintained with the correspondent or in which the correspondent has only been approved for a limited relationship. Although in many cases it will be necessary for a bank to establish formal internal limits to meet

the regulatory limit, the provisions of section 206.3 (prudential standards) concerning excesses over internal limits also apply to limits established for the purpose of controlling credit exposure under section 206.4 of Regulation F.

# Interbank Liabilities

## Examination Objectives

Effective date May 2006

## Section 2015.2

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The following examination objectives should be considered when examiners are (1) evaluating the bank's interbank liabilities with respect to its credit exposures to correspondents and (2) assessing the bank's compliance with Regulation F.

1. To determine if the policies, practices, procedures, and internal controls for interbank liabilities adequately address the risks posed by the bank's exposure to other domestic depository institutions and foreign banks.
2. To determine if bank officers and employees are operating in compliance with the policies and procedures established by the bank.
3. To determine if the financial condition of correspondents to which the bank has significant exposure—significant both in the size and maturity of the exposure and the financial condition of the correspondent—is reviewed periodically.
4. To determine if internal limits on exposure (1) have been established where necessary and (2) are consistent with the risk undertaken.
5. To determine if (1) exposure ordinarily remains within the established internal limits and (2) appropriate procedures have been established to address excesses over internal limits.
6. To determine that a bank's credit exposure to less than adequately capitalized correspondents is not more than 25 percent of the exposed bank's total capital. (Note that Regulation F places greater emphasis on maintaining appropriate levels of exposure based on a bank's analysis of the creditworthiness of its correspondents as opposed to merely staying within regulatory established limits.)
7. To determine if those correspondents to which the bank has credit exposure exceeding 25 percent of total capital are monitored quarterly to ensure that such correspondents remain at least adequately capitalized.
8. To reach agreement with the board of directors and senior management to initiate corrective action when policies, procedures, or internal controls are deficient, or when there are violations of laws or regulations.

# Interbank Liabilities

## Examination Procedures

Effective date May 2006

## Section 2015.3

Examiners should obtain or prepare the information necessary to perform the appropriate procedural steps.

1. If selected for implementation, complete or update the “Interbank Liabilities” section of the internal control questionnaire.
2. On the basis of an evaluation of the bank’s internal controls, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures.
4. Request bank files relating to its exposure to its correspondents, as exposure is defined in Regulation F and applied and used in the “Prudential Standards” section of the regulation.
  - a. Request documentation demonstrating that the bank has periodically reviewed the financial condition of any correspondent to which the depository institution has significant exposure. Factors bearing on the financial condition of the correspondent that should be addressed by the bank (depository institution) include the capital level of the correspondent, the level of nonaccrual and past-due loans and leases, the level of earnings, and other factors affecting the financial condition of the correspondent.
  - b. Request that the bank provide information indicating its level of exposure to each correspondent, as measured by the bank’s internal control systems (for smaller banks, this information may include correspondent statements and a list of securities held in the investment portfolio).
  - c. Determine if the frequency of the bank’s reviews of its correspondents’ financial condition is adequate for those correspondents to which the bank has very large or long maturities or for correspondents in deteriorating condition.
  - d. If a bank relies on another party (such as a bank rating agency, its bank holding company, or another correspondent) to provide financial analysis of a correspondent, determine if the bank’s board of directors has reviewed and approved the assessment criteria used by the other party.
- e. When the bank relies on its bank holding company or on a correspondent, such as a bankers’ bank, to select and monitor correspondents or to choose other correspondents with which to place the depository institution’s federal funds, ensure that the bank’s board of directors has reviewed and approved the selection criteria used.
- f. If the bank is exposed to a correspondent that has experienced deterioration in its financial condition, ascertain whether the bank has taken the deterioration into account in its evaluation of the credit-worthiness of the correspondent and of the appropriate level of exposure to the correspondent.
- g. When the bank has established internal limits for significant exposure, determine that the bank either monitors its exposure or structures transactions with the correspondent to ensure that exposure ordinarily remains within the bank’s internal limits for the risk undertaken.
- h. If the bank chooses to set separate limits for different forms of exposure, products, or maturities and does not set an overall internal limit on exposure to a correspondent, review information on actual inter-day exposure to determine if the aggregate exposure (especially for less than adequately capitalized correspondents or financially deteriorating correspondents) is consistent with the risk undertaken.
- i. When a bank monitors its exposures, determine if the level of monitoring of significant exposure (especially for less than adequately capitalized correspondents or financially deteriorating correspondents) is adequate, commensurate with the type and volatility of exposure, the extent to which the exposure approaches the bank’s internal limits, and the condition of the correspondent.
- j. Determine if the bank had any occasional excesses in exposure over its internal limits. If so, verify that the bank used appropriate and adequate procedures to address such excesses.
- k. If the size of intraday exposure to a

correspondent and the condition of the correspondent indicate a significant risk that payments will not be made in full or in a timely manner, verify that the bank has established intraday limits consistent with the risk undertaken and that it has monitored its intraday exposure.

5. Request and review a list of the correspondent transaction files for all domestic depository institutions and foreign banks to which the bank regularly has credit exposure (as defined in section 206.4 of Regulation F) exceeding 25 percent of the bank's total capital during a specified time interval. (Where appropriate, every effort should be made to allow banks to use existing risk-

monitoring and -control systems and practices when these systems and practices effectively maintain credit exposure within the prescribed limits). Review the bank's files to—

- a. verify that the correspondent's capital levels are monitored quarterly;
- b. verify that these correspondents are at least adequately capitalized, in compliance with Regulation F; and
- c. determine that the credit exposure to those correspondents that are at risk of dropping below the adequately capitalized capital levels could be reduced to 25 percent or less of the bank's total capital in a timely manner.

# Interbank Liabilities

## Internal Control Questionnaire

Effective date May 2006

## Section 2015.4

Review the bank's internal controls, policies, practices, and procedures for interbank liabilities and compliance with the Board's Regulation F. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. When identifying and resolving any existing deficiencies, examiners should seek the answers to the following key questions.

### PRUDENTIAL STANDARDS

1. Has the bank developed written policies and procedures to evaluate and control its exposure to all of its correspondents?
2. Have the written policies and procedures been reviewed and approved by the board of directors annually?
3. Do the written policies and procedures adequately address the bank's exposure(s) to a correspondent, including credit risk, liquidity risk, operational risk, and settlement risk?
4. Has the bank adequately evaluated its intraday exposure? Does the bank have significant exposure to its correspondent from operational risks, such as extensive reliance on a correspondent for data processing? If so, has the bank addressed these operational risks?
5. Do the bank's written policies and procedures establish criteria for selecting a correspondent or terminating that relationship?
6. Do the bank's written policies and procedures require a periodic review of the financial condition of a correspondent whenever the size and maturity of exposure is considered significant in relation to the financial condition of the correspondent?
7. When exposure is considered significant, is the financial condition of a correspondent periodically reviewed?
8. Does the periodic review of a correspondent's financial condition include—
  - a. the level of capital?
  - b. the level of nonaccrual and past-due loans and leases?
  - c. the level of earnings?
  - d. other factors affecting the financial condition of the correspondent?
9. If a party other than bank management conducts the financial analysis of or selects a correspondent, has the bank's board of directors reviewed and approved the general assessment and selection criteria used by that party?
10. If the financial condition of a correspondent, or the form or maturity of the bank's exposure to that correspondent, creates significant risk, do the bank's written policies and procedures establish internal limits or other procedures, such as monitoring, to control exposure?
11. Are the bank's internal limits or controls appropriate for the level of its risk exposure to correspondents? If no internal limits have been established, is this appropriate based on the financial condition of a correspondent and the size, form, and maturity of the bank's exposure? What are your reasons for this conclusion?
12. When internal limits for significant exposure to a correspondent have been set, has the bank established procedures and structured its transactions with the correspondent to ensure that the exposure ordinarily remains within the bank's established internal limits?
13. If not, is actual exposure to a correspondent monitored to ensure that the exposure ordinarily remains within the bank's established internal limits?
14. Is the level (frequency) of monitoring performed appropriate for—
  - a. the type and volatility of the exposure?
  - b. the extent to which the exposure approaches the bank's internal limits?
  - c. the financial condition of the correspondent?
15. Are transactions and monitoring reports on exposure reviewed for compliance with internal policies and procedures? If so, by whom and how often?
16. Do the bank's written policies and procedures address deterioration in a correspondent's financial condition with respect to—
  - a. the periodic review of the correspondent's financial condition?
  - b. appropriate limits on exposure?
  - c. the monitoring of the exposure, or the structuring of transactions with the cor-

respondent, to ensure that the exposure remains within the established internal limits?

Are these measures appropriate and realistic?

17. Do the bank's written procedures establish guidelines to address excesses over its internal limits? (Such excesses could include unusual late incoming wires, unusually large foreign cash letters (international pouch), unusual market moves, or other unusual increases in activity or operational problems.) Are the procedures appropriate?
2. If credit exposure is not limited to 25 percent or less of the bank's total capital, does the bank—
  - a. obtain quarterly information to determine its correspondent's capital levels (if so, determine the source of the information)?
  - b. monitor its overnight credit exposure to its correspondents (if so, determine the frequency)?

## CREDIT-EXPOSURE LIMITS

1. Do the bank's written policies and procedures effectively limit overnight credit expo-



This interagency guidance reminds institutions of supervisory expectations on sound practices for managing risks associated with funding and credit concentrations arising from correspondent relationships (correspondent concentration risk).<sup>1</sup> The guidance highlights the need for institutions to identify, monitor, and manage correspondent concentration risk on a standalone and organization-wide basis and to take into account exposures to the correspondents' affiliates as part of their prudent risk-management practices. Institutions also should be aware of their affiliates' exposures to correspondents as well as the correspondents' subsidiaries and affiliates. The guidance also reinforces the supervisory view that financial institutions should perform appropriate due diligence on all credit exposures to, and funding transactions with, other financial institutions. See SR-10-10 and its attachments. Also see 75 *Fed. Reg.* 23764, May 4, 2010.

### INTERAGENCY GUIDANCE ON CORRESPONDENT CONCENTRATION RISKS

A financial institution's<sup>2</sup> relationship with a correspondent<sup>3</sup> may result in credit (asset) and funding (liability) concentrations. On the asset side, a credit concentration represents a significant volume of credit exposure that a financial institution has advanced or committed to a correspondent. On the liability side, a funding concentration exists when an institution depends on one or a few correspondents for a disproportionate share of its total funding.

The Federal Reserve<sup>4</sup> realizes some concen-

trations meet certain business needs or purposes, such as a concentration arising from the need to maintain large "due from" balances to facilitate account clearing activities. However, correspondent concentrations represent a lack of diversification, which adds a dimension of risk that management should consider when formulating strategic plans and internal risk limits.

The Federal Reserve considers credit exposures greater than 25 percent of total capital<sup>5</sup> as concentrations. While a liability concentration threshold has not been established, the Federal Reserve has seen instances where funding exposures as low as 5 percent of an institution's total liabilities have posed an elevated liquidity risk to the recipient institution.

These levels of credit and funding exposures are not firm limits but indicate an institution has concentration risk with a correspondent. Such relationships warrant robust risk-management practices, particularly when aggregated with other similarly sized funding concentrations, in addition to meeting the minimum regulatory requirements specified in applicable regulations. Financial institutions should identify, monitor, and manage both asset and liability correspondent concentrations and implement procedures to perform appropriate due diligence on all credit exposures to and funding transactions with correspondents, as part of their overall risk-management policies and procedures.

This guidance does not supplant or amend applicable regulations, such as the Board's *Limitations on Interbank Liabilities* (Regulation F).<sup>6</sup> This guidance clarifies that financial institutions should consider taking actions beyond the minimum requirements established in Regulation F to identify, monitor, and manage correspondent concentration risks in order to maintain risk-management practices consistent with safe and sound operations, especially when there are rapid changes in market conditions or in a correspondent's financial condition.

1. See, for example, section 2015.1 or SR-93-36.

2. This guidance applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, and savings and loan holding companies and their subsidiaries that are supervised by the Board of Governors of the Federal Reserve System.

3. Unless the context indicates otherwise, references to "correspondent" include the correspondent's holding company, subsidiaries, and affiliates. A correspondent relationship results when a financial organization provides another financial organization a variety of deposit, lending, or other services.

4. The interagency guidance references, collectively, the Agencies, meaning the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

5. For purposes of this guidance, the term "total capital" means the total risk-based capital as reported for commercial banks and thrifts in the Report of Condition and the Thrift Financial Report, respectively.

6. 12 CFR 206. All depository institutions insured by the FDIC are subject to the Board's Regulation F.

## Identifying Correspondent Concentrations

Institutions should implement procedures for identifying correspondent concentrations. For prudent risk-management purposes, these procedures should encompass the totality of the institutions' aggregate credit and funding concentrations to each correspondent on a standalone basis, as well as take into account exposures to each correspondent organization as a whole.<sup>7</sup> In addition, the institution should be aware of exposures of its affiliates to the correspondent and its affiliates.

## Credit Concentrations

Credit concentrations can arise from a variety of assets and activities. For example, an institution could have due from bank accounts, federal funds sold on a principal basis and direct or indirect loans to, or investments in, a correspondent. In identifying credit concentrations for risk-management purposes, institutions should aggregate all exposures, including but not limited to

- due from bank accounts (demand deposit accounts (DDA) and certificates of deposit (CD));
- federal funds sold on a principal basis;
- the over-collateralized amount on repurchase agreements;
- the under-collateralized portion of reverse repurchase agreements;
- net current credit exposure on derivatives contracts;
- unrealized gains on unsettled securities transactions;
- direct or indirect loans to, or for the benefit of, the correspondent;<sup>8</sup> and
- investments, such as trust preferred securities, subordinated debt, and stock purchases, in the correspondent.

7. Financial institutions should identify and monitor all direct or indirect relationships with their correspondents. Institutions should take into account exposures of their affiliates to correspondents and how those relationships may affect the institution's exposure. While each financial institution is responsible for monitoring its own credit and funding exposures, institution holding companies, if any, should manage their organizations' concentration risk on a consolidated basis.

8. Exclude loan participations purchased without recourse from a correspondent, its holding company, or an affiliate.

## Funding Concentrations

Depending on its size and characteristics, a concentration of credit for a financial institution may be a funding exposure for the correspondent. The primary risk of a funding concentration is that an institution will have to replace those advances on short notice. This risk may be more pronounced if the funds are credit sensitive or if the financial condition of the party advancing the funds has deteriorated.

The percentage of liabilities or other measurements that may constitute a concentration of funding is likely to vary depending on the type and maturity of the funding and the structure of the recipient's sources of funds. For example, a concentration in overnight unsecured funding from one source might raise different concentration issues and concerns than unsecured term funding, assuming compliance with covenants and diversification with short- and long-term maturities. Similarly, concerns arising from concentrations in long-term unsecured funding typically increase as these instruments near maturity.

## Calculating Credit and Funding Concentrations

When identifying credit and funding concentrations for risk-management purposes, institutions should calculate both gross and net exposures to the correspondent on a standalone basis and on a correspondent organization-wide basis as part of their prudent risk-management practices. Exposures are reduced to net positions to the extent that the transactions are secured by the net realizable proceeds from readily marketable collateral or are covered by valid and enforceable netting agreements. Appendix A and appendix B contain examples, which are provided for illustrative purposes only.

## Monitoring Correspondent Relationships

Prudent management of correspondent concentration risks includes establishing and maintaining written policies and procedures to prevent excessive exposure to any correspondent in relation to the correspondent's financial condition. For risk-management purposes, institu-

tions' procedures and frequency for monitoring correspondent relationships may be more or less aggressive depending on the nature, size, and risk of the exposure.

In monitoring correspondent relationships for risk-management purposes, institutions should specify internal parameters relative to what information, ratios, or trends will be reviewed for each correspondent on an ongoing basis. In addition to a correspondent's capital, level of problem loans, and earnings, institutions may want to monitor other factors, which could include but are not limited to

- deteriorating trends in capital or asset quality.
- reaching certain target ratios established by management (for example, aggregate of non-accrual and past due loans and leases as a percentage of gross loans and leases).
- increasing level of other real estate owned.
- attaining internally specified levels of volatile funding sources such as large CDs or brokered deposits.
- experiencing a downgrade in its credit rating, if publicly traded.
- being placed under a public enforcement action.

For prudent risk-management purposes, institutions should implement procedures that ensure ongoing, timely reviews of correspondent relationships. Institutions should use these reviews to conduct comprehensive assessments that consider their internal parameters and are commensurate with the nature, size, and risk of their exposure. Institutions should increase the frequency of their internal reviews when appropriate, as even well-capitalized institutions can experience rapid deterioration in their financial condition, especially in economic downturns.

Institutions' procedures also should establish documentation requirements for the reviews conducted. In addition, the procedures should specify when relationships that meet or exceed internal criteria are to be brought to the attention of the board of directors or the appropriate management committee.

## Managing Correspondent Concentrations

Institutions should establish prudent internal concentration limits, as well as ranges or toler-

ances for each factor being monitored for each correspondent. Institutions should develop plans for managing risk when these internal limits, ranges, or tolerances are met or exceeded, either on an individual or collective basis. Contingency plans should provide a variety of actions that could be considered relative to changes in the correspondent's financial condition. However, contingency plans should not rely on temporary deposit insurance programs for mitigating concentration risk.

Prudent risk management of correspondent concentration risks should include procedures that provide for orderly reductions of correspondent concentrations that exceed internal parameters over a reasonable timeframe that is commensurate with the size, type, and volatility of the risk in the exposure. Such actions could include, but are not limited to

- reducing the volume of uncollateralized/uninsured funds.
- transferring excess funds to other correspondents after conducting appropriate reviews of their financial condition.
- requiring the correspondent to serve as agent rather than as principal for federal funds sold.
- establishing limits on asset and liability purchases from, and investments in, correspondents.
- specifying reasonable timeframes to meet targeted reduction goals for different types of exposures.

Examiners will review correspondent relationships during examinations to ascertain whether an institution's policies and procedures appropriately identify and monitor correspondent concentrations. Examiners also will review the adequacy and reasonableness of institutions' contingency plans to manage correspondent concentrations.

## Performing Appropriate Due Diligence

Financial institutions that maintain credit exposures in, or provide funding to, other financial institutions should have effective risk-management programs for these activities. For this purpose, credit or funding exposures may include but are not limited to due from bank accounts; federal funds sold as principal; direct or indirect loans (including participations and

syndications); trust preferred securities; subordinated debt; and stock purchases of the correspondent.

An institution that maintains or contemplates entering into any credit or funding transactions with another financial institution should have written investment, lending, and funding policies and procedures, including appropriate limits, that govern these activities. In addition,

these procedures should ensure that the institution conducts an independent analysis of credit transactions prior to committing to engage in the transactions. The terms for all such credit and funding transactions should strictly be on an arm's-length basis; conform to sound investment, lending, and funding practices; and avoid potential conflicts of interest.

## APPENDIX A

### Calculating Respondent *Credit Exposures* on an *Organization-Wide* Basis

#### Respondent Bank's *Gross Credit Exposure* to a Correspondent, its Holding Company, and Affiliates

Due from DDA with correspondent .....	\$ 50,000,000
Due from DDA with correspondent's two affiliated insured depository institutions (IDIs) .....	1,000,000
CDs issued by correspondent bank .....	1,000,000
CDs issued by one of correspondent's two affiliated IDIs .....	500,000
Federal funds sold to correspondent on a principal basis .....	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis .....	2,500,000
Reverse repurchase agreements .....	3,750,000
Net current credit exposure on derivatives <sup>1</sup> .....	250,000
Direct and indirect loans to, or for benefit of, a correspondent, its holding company, or affiliates .....	4,500,000
Investments in the correspondent, its holding company, or affiliates .....	<u>2,500,000</u>
<b>Gross Credit Exposure</b> .....	<b>\$117,500,000</b>
<b>Total Capital</b> .....	<b>\$100,000,000</b>
<b>Gross Credit Concentration</b> .....	<b>118%</b>

#### Respondent Bank's *Net Credit Exposure* to a Correspondent, its Holding Company, and Affiliates

Due from DDA (less checks/cash not available for withdrawal and federal deposit insurance (FDI)) <sup>2</sup> .....	\$ 17,850,000
Due from DDA with correspondent's two affiliated IDIs (less FDI) <sup>2</sup> .....	500,000
CDs issued by correspondent bank (less FDI) .....	750,000
CDs issued by one of correspondent's two affiliated IDIs (less FDI) .....	250,000
Federal funds sold on a principal basis .....	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis .....	2,500,000
Under-collateralized amount on reverse repurchase agreements (less the current market value of government securities or readily marketable collateral pledged) <sup>3</sup> ...	100,000
Uncollateralized net current derivative position <sup>1</sup> .....	50,000
Direct and indirect loans to, or for benefit of, a correspondent, its holding company, or affiliates .....	4,500,000
Investments in the correspondent, its holding company, or affiliates .....	<u>2,500,000</u>
<b>Net Credit Exposure</b> .....	<b>\$ 80,500,000</b>
<b>Total Capital</b> .....	<b>\$100,000,000</b>
<b>Net Credit Concentration</b> .....	<b>81%</b>

## APPENDIX A—continued

Calculating Correspondent *Funding Exposures* on an *Organization-Wide* BasisCorrespondent's *Gross Funding Exposure* to a Respondent Bank

Due to DDA with respondent .....	\$ 50,000,000
Correspondent's two affiliated IDIs' due to DDA with respondent .....	1,000,000
CDs sold to respondent bank .....	1,000,000
CDs sold to respondent from one of correspondent's two affiliated IDIs .....	500,000
Federal funds purchased from respondent on a principal basis .....	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis .....	2,500,000
Repurchase Agreements .....	1,000,000
<b>Gross Funding Exposure</b> .....	<b>\$ 107,500,000</b>
<b>Total Liabilities</b> .....	<b>\$1,350,000,000</b>
<b>Gross Funding Concentration</b> .....	<b>7.96%</b>

Correspondent's *Net Funding Exposure* to a Respondent, its Holding Company, and Affiliates

Due to DDA with respondent (less checks and cash not available for withdrawal and FDI) <sup>2</sup> .....	\$ 17,850,000
Correspondent's two affiliated IDIs' due to DDA with respondent (less FDI) <sup>2</sup> .....	500,000
CDs sold to correspondent (less FDI) .....	750,000
One of correspondent's two affiliated IDIs' CDs sold to respondent (less FDI) <sup>2</sup> .....	250,000
Federal funds purchased from respondent on a principal basis .....	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis .....	2,500,000
Under-collateralized amount of repurchase agreements relative to the current market value of government securities or readily marketable collateral pledged <sup>3</sup> .....	150,000
<b>Net Funding Exposure</b> .....	<b>\$ 73,500,000</b>
<b>Total Liabilities</b> .....	<b>\$1,350,000,000</b>
<b>Net Funding Concentration</b> .....	<b>5.44%</b>

Note: Respondent bank has \$1 billion in total assets, comprising 10 percent of total assets or \$100 million in total capital and 90 percent of total assets or \$900 million in total liabilities. The correspondent has \$1.5 billion in total assets, comprising 10 percent of total assets or \$1.15 billion in total capital and 90 percent of total assets or \$1.35 billion in total liabilities.

1. There are five derivative contracts with a mark-to-market fair value position as follows: Contract 1 (\$100,000), Contract 2 + \$400,000, Contract 3 (\$50,000), Contract 4 +\$150,000, and Contract 5 (\$150,000), subtotal of \$250,000 fair value for the derivative contracts. Subtracting the pledged collateral's fair value of \$200,000 leaves a subtotal of \$50,000 or a net uncollateralized position of \$50,000.

2. While temporary deposit insurance programs may provide certain transaction accounts with higher levels of federal deposit insurance coverage, institutions should not rely on such programs for mitigating concentration risk.

3. Government securities means obligations of, or obligations fully guaranteed as to principal and interest by, the U.S. government or any department, agency, bureau, board, commission, or establishment of the United States, or any corporation wholly owned, directly or indirectly, by the United States.

## APPENDIX B

Calculating Respondent *Credit Exposures* on a *Correspondent-Only* BasisRespondent Bank's *Gross Credit Exposure* to a Correspondent

Due from DDA with correspondent .....	\$ 50,000,000
Due from DDA with correspondent's two affiliated IDIs .....	0
CDs issued by correspondent bank .....	1,000,000
CDs issued by one of correspondent's two affiliated IDIs .....	0
Federal funds sold to correspondent on a principal basis .....	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis .....	0
Reverse repurchase agreements .....	3,750,000
Net current credit exposure on derivatives <sup>1</sup> .....	250,000
Direct and indirect loans to, or for benefit of, a correspondent, its holding company, or affiliates .....	4,500,000
Investments in the correspondent, its holding company, or affiliates .....	<u>2,500,000</u>
<b>Gross Credit Exposure</b> .....	<b>\$ 113,500,000</b>
<b>Total Capital</b> .....	<b>\$ 100,000,000</b>
<b>Gross Credit Concentration</b> .....	<b>114%</b>

Respondent Bank's *Net Credit Exposure* to a Correspondent

Due from DDA (less checks/cash not available for withdrawal and FDI) <sup>2</sup> .....	\$ 17,850,000
Due from DDA with correspondent's two affiliated IDIs (less FDI) <sup>2</sup> .....	0
CDs issued by correspondent bank (less FDI) .....	750,000
CDs issued by one of correspondent's two affiliated IDIs (less FDI) .....	0
Federal funds sold on a principal basis .....	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis .....	0
Under-collateralized amount on reverse repurchase agreements (less the current market value of government securities or readily marketable collateral pledged) <sup>3</sup> ...	100,000
Uncollateralized net current derivative position <sup>1</sup> .....	50,000
Direct and indirect loans to, or for benefit of, a correspondent, its holding company, or affiliates .....	4,500,000
Investments in the correspondent, its holding company, or affiliates .....	<u>2,500,000</u>
<b>Net Credit Exposure</b> .....	<b>\$ 77,250,000</b>
<b>Total Capital</b> .....	<b>\$ 100,000,000</b>
<b>Net Credit Concentration</b> .....	<b>77%</b>

## APPENDIX B—continued

Calculating Correspondent *Funding Exposures* on a *Correspondent-Only* BasisCorrespondent's *Gross Funding Exposure* to a Respondent

Due to DDA with respondent .....	\$ 50,000,000
Correspondent's two affiliated IDIs' due to DDA with respondent .....	0
CDs sold to respondent bank .....	1,000,000
CDs sold to respondent from one of correspondent's two affiliated IDIs .....	0
Federal funds purchased from respondent on a principal basis .....	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis .....	0
Repurchase agreements .....	1,000,000
<b>Gross Funding Exposure</b> .....	<b>\$ 103,500,000</b>
<b>Total Liabilities</b> .....	<b>\$1,350,000,000</b>
<b>Gross Funding Concentration</b> .....	<b>7.67%</b>

Correspondent's *Net Funding Exposure* to a Respondent

Due to DDA with respondent (less checks and cash not available for withdrawal and FDI) <sup>2</sup> .....	\$ 17,850,000
Correspondent's two affiliated IDIs' due to DDA with respondent (less FDI) <sup>2</sup> .....	0
CDs sold to correspondent (less FDI) .....	750,000
One of correspondent's two affiliated IDIs' CDs sold to respondent (less FDI) <sup>2</sup> .....	0
Federal funds purchased from respondent on a principal basis .....	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis .....	0
Under-collateralized amount on repurchase agreements (less the current market value of government securities or readily marketable collateral pledged) <sup>3</sup> .....	100,000
<b>Net Funding Exposure</b> .....	<b>\$ 70,200,000</b>
<b>Total Liabilities</b> .....	<b>\$1,350,000,000</b>
<b>Net Funding Concentration</b> .....	<b>5.20%</b>

Note: Respondent bank has \$1 billion in total assets, comprising 10 percent of total assets or \$100 million in total capital and 90 percent of total assets or \$900 million in total liabilities. The correspondent has \$1.5 billion in total assets, comprising 10 percent of total assets or \$1.15 billion in total capital and 90 percent of total assets or \$1.35 billion in total liabilities.

1. There are five derivative contracts with a mark-to-market fair value position as follows: Contract 1 (\$100,000), Contract 2 + \$400,000, Contract 3 (\$50,000), Contract 4 +\$150,000, and Contract 5 (\$150,000), subtotal of \$250,000 fair value. Adding the collateral's fair value of \$200,000 leaves a subtotal of \$450,000 or a net uncollateralized position of \$50,000.

2. While temporary deposit insurance programs may provide certain transaction accounts with higher levels of federal deposit insurance coverage, institutions should not rely on such programs for mitigating concentration risk.

3. Government securities means obligations of, or obligations fully guaranteed as to principal and interest by, the U.S. government or any department, agency, bureau, board, commission, or establishment of the United States, or any corporation wholly owned, directly or indirectly, by the United States.

This section provides guidance on the management of a depository institution's investment and end-user activities. The guidance applies to (1) all securities in held-to-maturity and available-for-sale accounts as defined in the Statement of FASB Accounting Standards Codification Section 320-10-35, Investments—Debt and Equity Securities—Overall—Subsequent Measurement (formerly FAS 115, "Accounting for Certain Investments in Debt and Equity Securities"), (2) all certificates of deposit held for investment purposes, and (3) all derivative contracts not held in trading accounts (end-user derivative contracts).<sup>1</sup> The guidance also covers all securities used for investment purposes, including money market instruments, fixed- and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage-derivative products. The section discusses an institution's maintenance of timely information about market risk-measurement systems, including the information on the current carrying values of its securities and derivative holdings. This includes the institution's use of internal models and its need to validate the models. (See SR-11-7.) End-user derivative instruments used for nontrading purposes, such as swaps, futures, and options, are also discussed.

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

- the permissibility and appropriateness of securities holdings by state member banks;
- sound risk-management practices and internal controls used by banking institutions in their investment and end-user activities;
- the review of securities and derivatives acquired by the bank's international division and overseas branches for its own account as well as the bank's foreign equity investments

that are held either directly or through Edge Act corporations;

- banking agency policies on certain high-risk mortgage-derivative products; and
- unsuitable investment practices.

### LIMITATIONS AND RESTRICTIONS ON SECURITIES HOLDINGS

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

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

1. Derivatives, in general, are financial contracts whose values are derived from the value of one or more underlying assets, interest rates, exchange rates, commodities, or financial or commodity indexes.



Table 1—Summary of Rating Systems

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

terparty, the bank should supplement bond ratings with its own credit analysis of the issuer. (See table 1 for a summary of the above-mentioned rating systems.)

### Bank-Eligible Securities

The OCC's investment securities regulation identifies five basic types of investment securities

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

Table 2—Summary of New Investment-Type Categories

<i>Type Category</i>	<i>Characteristics</i>	<i>Limitations</i>
Type I securities	<ul style="list-style-type: none"> <li>• U.S. government securities</li> <li>• general obligations of a state or political subdivision</li> <li>• municipal bond activities by well-capitalized* banks, other than types II, III, IV, or V securities</li> <li>• obligations backed by the full faith and credit of the U.S. government</li> <li>• FHLB, Fannie Mae, and FHLMC debt or similarly collateralized debt of a state or political subdivision backed by the full faith and credit of the U.S. government</li> </ul>	No limitations on banks' investment, dealing, or underwriting abilities. With respect to all municipal securities, a member bank that is well-capitalized* may deal in, underwrite, purchase, and sell any municipal bond for its own account without any limit tied to the bank's capital and surplus.
Type II securities	<ul style="list-style-type: none"> <li>• state obligations for housing, university, or dormitory purposes that would not qualify as a type I municipal security</li> <li>• obligations of international development banks</li> <li>• debt of Tennessee Valley Authority</li> <li>• debt of U.S. Postal Service</li> <li>• obligations that a national bank is authorized to deal in, underwrite, purchase, or sell under 12 USC 24 (seventh), other than type I securities</li> </ul>	Banks may deal in, underwrite, or invest subject to the limitation that the aggregate par value of the obligation of any one obligor may not exceed 10 percent of a bank's capital and surplus.
Type III securities	<ul style="list-style-type: none"> <li>• an investment security that does not qualify as type I, II, IV, or V</li> <li>• municipal revenue bonds, except those that qualify as a type I municipal security</li> <li>• corporate bonds</li> </ul>	The aggregate par value of a bank's purchases and sales of the securities of any one obligor may not exceed 10 percent of a bank's capital and surplus.

continued

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

<i>Type Category</i>	<i>Characteristics</i>	<i>Limitations</i>
Type IV securities	<ul style="list-style-type: none"> <li>• small business–related securities that are rated investment-grade or the equivalent and that are fully secured by a loan pool</li> <li>• residential or commercial mortgage–related securities rated AA or Aa or higher</li> </ul>	<p>For securities rated AA or Aa or higher, no investment limitations.</p> <p>For lower-rated investment-grade securities, the aggregate par value of a bank’s purchases and sales of the securities of any one obligor may not exceed 25 percent of a bank’s capital and surplus.</p> <p>For mortgage-related securities, no investment limitations.</p> <p>A bank may deal in type IV securities with limitation.</p>
Type V securities	<ul style="list-style-type: none"> <li>• asset-backed securities (credit card, auto, home equity, student loan, manufactured housing) that are investment-grade and are marketable</li> <li>• residential and commercial mortgage–related securities rated below AA or Aa, but still investment-grade</li> </ul>	<p>The aggregate par value of a bank’s purchases and sales of the securities of any one obligor may not exceed 25 percent of a bank’s capital and surplus.</p>

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

Type II securities are those debt instruments that national and state member banks may deal in, underwrite, purchase, and sell for their own account subject to a 10 percent limitation of a bank’s capital and surplus for any one obligor. Type II investments include obligations issued by the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the Tennessee Valley Authority, and the U.S. Postal Service, as well as obligations issued by any state or political subdivision for housing, uni-

versity, or dormitory purposes that do not qualify as a type I security and other issuers specifically identified in 12 USC 24(7).

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

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

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

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

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

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

As mentioned above, type III securities represent a residual category. The OCC requires a national bank to determine (1) that the type III instrument it plans to purchase is marketable and of sufficiently high investment quality and (2) that the obligor will be able to meet all payments and fulfill all the obligations it has undertaken in connection with the security. For example, junk bonds, which are often issued to

finance corporate takeovers, are usually not considered to be of investment quality because they are predominately speculative and have limited marketability.

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

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

## Reservation of Authority

In addition to the investment securities discussed in 12 USC 24 (seventh), the OCC may determine, on a case-by-case basis, that a national bank may acquire an investment security other than an investment security of a type set forth in this part, provided the OCC determines that the bank's investment is consistent with 12 USC 24 (seventh) and with safe and sound banking practices. (See *73 Fed. Reg.* 22,235, April 24, 2008, and 12 CFR 1.1 for more information.) A state member bank should consult the Board for a determination with respect to the application

of 12 USC 24 (seventh), with respect to issues not addressed in 12 CFR 1. The provisions of 12 CFR 1 do not provide authority for a state member bank to purchase securities of a type or amount that the bank is not authorized to purchase under applicable state law. (See 12 CFR 208.21(b).)

## Municipal Revenue Bonds

Upon enactment of the Gramm-Leach-Bliley Act (the GLB Act), most state member banks were authorized to deal in, underwrite, purchase, and sell municipal revenue bonds (12 USC 24 (seventh)). Effective March 13, 2000, these activities (involving type I securities) could be conducted by well-capitalized<sup>1a</sup> banks, without limitation as to the level of these activities relative to the bank's capital. Previously, banks were limited to only underwriting, dealing in, or investing in, without limitation, general obligation municipal bonds backed by the full faith and credit of an issuer with general powers of taxation. Member banks could purchase for their own account, but not underwrite or deal in, municipal revenue bonds, but the purchases and sales of such investment securities for any obligor were limited to 10 percent of a member bank's capital and surplus. As a result of the GLB Act amendment, municipal revenue bonds are the equivalent of type I securities for well-capitalized state member banks.<sup>1b</sup> (See SR-01-13.)

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

erning these activities and make them available to examiners upon request.

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

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

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

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

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

## UNIFORM AGREEMENT ON THE CLASSIFICATION OF ASSETS AND THE APPRAISAL OF SECURITIES

On June 15, 2004, the agencies<sup>1c</sup> issued a joint interagency statement that revised the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts (the uniform agreement). (See SR-04-9.) The uniform agreement amends the examination procedures that were established in 1938 and then revised and issued on July 15, 1949, and on May 7, 1979. The uniform agreement sets forth the definitions of the classification categories and the specific examination procedures and information for classifying bank assets, including securities. The uniform agreement's classi-

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<sup>1c</sup>. The statement was issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (the agencies).

fication of loans remains unchanged from the 1979 revision.

The June 15, 2004, agreement changes the classification standards applied to banks' holdings of debt securities by—

- eliminating the automatic classification of sub-investment-grade debt securities when a banking organization has developed an accurate, robust, and documented credit-risk-management framework to analyze its securities holdings;
- conforming the uniform agreement to current generally accepted accounting principles by basing the recognition of depreciation on all available-for-sale securities on the bank's determination as to whether the impairment of the underlying securities is "temporary" or "other than temporary";
- eliminating the preferential treatment given to defaulted municipal securities;
- clarifying how examiners should address securities that have two or more different ratings, split or partially rated securities, and nonrated debt securities;
- identifying when examiners may diverge from conforming their ratings to those of the rating agencies; and
- addressing the treatment of Interagency Country Exposure Review Committee ratings.

The uniform agreement's classification categories also apply to the classification of assets held by the subsidiaries of banks. *Although the classification categories for bank assets and assets held by bank subsidiaries are the same, the classification standards may be difficult to apply to the classification of subsidiary assets because of differences in the nature and risk characteristics of the assets.* Despite the differences that may exist between assets held directly by a bank and those held by its subsidiary, the standards for classifying investment securities are to be applied directly to securities held by a bank and its subsidiaries.

## Classification of Assets in Examinations

Classification units are designated as Substandard, Doubtful, and Loss. A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of

the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. An asset classified Doubtful has all the weaknesses inherent in one classified Substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified Loss should be promptly charged off.

## Appraisal of Securities in Bank Examinations

In an effort to streamline the examination process and achieve as much consistency as possible, examiners will use the published ratings provided by nationally recognized statistical ratings organizations (NRSROs) as a proxy for the supervisory classification definitions. Examiners may, however, assign a more- or less-severe classification for an individual security, depending on a review of applicable facts and circumstances.

### *Investment-Quality Debt Securities*

Investment-quality debt securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group generally includes investment securities in the four highest rating categories provided by NRSROs and includes unrated debt securities of equivalent quality.

Because investment-quality debt securities do not exhibit weaknesses that justify an adverse classification rating, examiners will generally not classify them. However, published credit ratings occasionally lag demonstrated changes in credit quality, and examiners may, in limited cases, classify a security notwithstanding an

investment-grade rating. Examiners may use such discretion, when justified by credit information the examiner believes is not reflected in the rating, to properly reflect the security's credit risk.

### *Sub-Investment-Quality Debt Securities*

Sub-investment-quality debt securities are those in which the investment characteristics are distinctly or predominantly speculative. This group generally includes debt securities, including hybrid equity instruments (for example, trust preferred securities), in grades below the four highest rating categories; unrated debt securities of equivalent quality; and defaulted debt securities.

In order to reflect asset quality properly, an examiner may in limited cases "pass" a debt security that is rated below investment quality. Examiners may use such discretion when, for example, the institution has an accurate and robust credit-risk-management framework and has demonstrated, based on recent, materially positive credit information, that the security is the credit equivalent of investment grade.

### *Rating Differences*

Some debt securities may have investment-quality ratings by one (or more) rating agencies and sub-investment-quality ratings by others. Examiners will generally classify such securities, particularly when the most recently assigned rating is not investment quality. However, an examiner has discretion to "pass" a debt security with both investment-quality and sub-investment-quality ratings. The examiner may use that discretion if, for example, the institution has demonstrated through its documented credit analysis that the security is the credit equivalent of investment grade.

### *Split or Partially Rated Securities*

Some individual debt securities have ratings for principal but not interest. The absence of a rating for interest typically reflects uncertainty regarding the source and amount of interest the investor will receive. Because of the speculative nature of the interest component, examiners will generally classify such securities, regardless of the rating for the principal.

### *Nonrated Debt Securities*

The agencies expect institutions holding individually large nonrated debt security exposures, or having significant aggregate exposures from small individual holdings, to demonstrate that they have made prudent pre-acquisition credit decisions and have effective, risk-based standards for the ongoing assessment of credit risk. Examiners will review the institution's program for monitoring and measuring the credit risk of such holdings and, if the assessment process is considered acceptable, generally will rely upon those assessments during the examination process. If an institution has not established independent risk-based standards and a satisfactory process to assess the quality of such exposures, examiners may classify such securities, including those of a credit quality deemed to be the equivalent of subinvestment grade, as appropriate.

Some nonrated debt securities held in investment portfolios represent small exposures relative to capital, both individually and in aggregate. While institutions generally have the same supervisory requirements (as applicable to large holdings) to show that these holdings are the credit equivalent of investment grade at purchase, comprehensive credit analysis subsequent to purchase may be impractical and not cost effective. For such small individual exposures, institutions should continue to obtain and review available financial information, and assign risk ratings. Examiners may rely upon the bank's internal ratings when evaluating such holdings.

### *Foreign Debt Securities*

The Interagency Country Exposure Review Committee (ICERC) assigns transfer-risk ratings for cross-border exposures. Examiners should use the guidelines in this uniform agreement rather than ICERC transfer-risk ratings in assigning security classifications, except when the ICERC ratings result in a more-severe classification.

### *Treatment of Declines in Fair Value Below Amortized Cost on Debt Securities*

Under generally accepted accounting principles (GAAP), an institution must assess whether a



decline in fair value<sup>1d</sup> below the amortized cost of a security is a “temporary” or an “other-than-temporary” impairment. When the decline in fair value on an individual security represents “other-than-temporary” impairment, the cost basis of the security must be written down to fair value, thereby establishing a new cost basis for the security, and the amount of the write-down must be reflected in current-period earnings. If an institution’s process for assessing impairment is considered acceptable, examiners may use those assessments in determining the appropriate classification of declines in fair value below amortized cost on individual debt securities.

Any decline in fair value below amortized cost on defaulted debt securities will be classified as indicated in table 3. Apart from classification, for impairment write-downs or charge-offs on adversely classified debt securities, the existence of a payment default will generally be considered a presumptive indicator of “other-than-temporary” impairment.

## Classification of Other Types of Securities

Some investments, such as certain equity holdings or securities with equity-like risk and return profiles, have highly speculative performance characteristics. Examiners should generally classify such holdings based on an assessment of the applicable facts and circumstances.

## Summary Table of Debt Security Classification Guidelines

Table 3 outlines the uniform classification approach the agencies will generally use when assessing credit quality in debt securities portfolios.

The general debt security classification guidelines do not apply to private debt and equity holdings in a small business investment company or an Edge Act corporation. The uniform agreement does not apply to securities held in trading accounts, provided the institution dem-

onstrates through its trading activity a short-term holding period or holds the security as a hedge for a customer’s valid derivative contract.

## Credit-Risk-Management Framework for Securities

When an institution has developed an accurate, robust, and documented credit-risk-management framework to analyze its securities holdings, examiners may choose to depart from the general debt security classification guidelines in favor of individual asset review in determining whether to classify those holdings. A robust credit-risk-management framework entails appropriate pre-acquisition credit due diligence by qualified staff that grades a security’s credit risk based on an analysis of the repayment capacity of the issuer and the structure and features of the security. It also involves the ongoing monitoring of holdings to ensure that risk ratings are reviewed regularly and updated in a timely fashion when significant new information is received.

The credit analysis of securities should vary based on the structural complexity of the security, the type of collateral, and external ratings. The credit-risk-management framework should reflect the size, complexity, quality, and risk characteristics of the securities portfolio; the risk appetite and policies of the institution; and the quality of its credit-risk-management staff, and should reflect changes to these factors over time. Policies and procedures should identify the extent of credit analysis and documentation required to satisfy sound credit-risk-management standards.

## Transfers of Low-Quality Securities and Assets

The purchase of low-quality assets by a bank from an affiliated bank or nonbank affiliate is a violation of section 23A of the Federal Reserve Act. The transfer of low-quality securities from one depository institution to another may be done to avoid detection and classification during regulatory examinations; this type of transfer may be accomplished through participations, purchases or sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Broadly defined, low-quality securities include depreciated or sub-investment-quality securi-

<sup>1d</sup>. As currently defined under GAAP, the fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices are the best evidence of fair value and must be used as the basis for measuring fair value, if available.

Table 3—General Debt Security Classification Guidelines

<i>Type of security</i>	<i>Classification</i>		
	<i>Substandard</i>	<i>Doubtful</i>	<i>Loss</i>
Investment-quality debt securities with “temporary” impairment	—	—	—
Investment-quality debt securities with “other-than-temporary” impairment	—	—	Impairment
Sub-investment-quality debt securities with “temporary” impairment <sup>1</sup>	Amortized cost	—	—
Sub-investment-quality debt securities with “other-than-temporary” impairment, including defaulted debt securities	Fair value	—	Impairment

Note. Impairment is the amount by which amortized cost exceeds fair value.

1. For sub-investment-quality available-for-sale (AFS) debt securities with “temporary” impairment, amortized cost rather than the lower amount at which these securities are carried on the balance sheet, i.e., fair value, is classified Substandard. This classification is consistent with the regulatory capital treatment of AFS debt securities. Under GAAP, unrealized

gains and losses on AFS debt securities are excluded from earnings and reported in a separate component of equity capital. In contrast, these unrealized gains and losses are excluded from regulatory capital. Accordingly, the amount classified Substandard on these AFS debt securities, i.e., amortized cost, also excludes the balance-sheet adjustment for unrealized losses.

ties. Situations in which an institution appears to be concealing low-quality securities to avoid examination scrutiny and possible classification represent an unsafe and unsound activity.

Any situations involving the transfer of low-quality or questionable securities should be brought to the attention of Reserve Bank supervisory personnel who, in turn, should notify the local office of the primary federal regulator of the other depository institution involved in the transaction. For example, if an examiner determines that a state member bank or holding company has transferred or intends to transfer low-quality securities to another depository institution, the Reserve Bank should notify the recipient institution’s primary federal regulator of the transfer. The same notification requirement holds true if an examiner determines that a state member bank or holding company has acquired or intends to acquire low-quality secu-

rities from another depository institution. This procedure applies to transfers involving savings associations and savings banks, as well as commercial banking organizations.

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

### Permissible Stock Holdings

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

Table 4—Permitted Stock Holdings by Member Banks

<i>Type of stock</i>	<i>Authorizing statute and limitation</i>
Federal Reserve Bank	Federal Reserve Act, sections 2 and 9 (12 USC 282 and 321) and Regulation I (12 CFR 209). Subscription must equal 6 percent of the bank's capital and surplus, 3 percent paid in.
Safe deposit corporation	12 USC 24. 15 percent of capital and surplus.
Corporation holding bank premises	Federal Reserve Act, section 24A (12 USC 371(d)). 100 percent of capital stock. Limitation includes total direct and indirect investment in bank premises in any form (such as loans). Maximum limitation may be exceeded with permission of the Federal Reserve Bank for state member banks and the Comptroller of the Currency for national banks.
Small business investment company	Small Business Investment Act of August 21, 1958, section 302(b) (15 USC 682(b)). Banks are prohibited from acquiring shares of such a corporation if, upon making the acquisition, the aggregate amount of shares in small business investment companies then held by the bank would exceed 5 percent of its capital and surplus.
Edge Act and agreement corporations and foreign banks	Federal Reserve Act, sections 25 and 25A (12 USC 601 and 618). The aggregate amount of stock held in all such corporations may not exceed 10 percent of the member bank's capital and surplus. Also, the member bank must possess capital and surplus of \$1 million or more before acquiring investments pursuant to section 25.
Bank service company	Bank Service Corporation Act of 1958, section 2 (12 USC 1861 and 1862). (Redesignated as Bank Service Company Act.) 10 percent of paid in and unimpaired capital and surplus. Limitation includes total direct and indirect investment in any form. No insured banks shall invest more than 5 percent of their total assets.
Federal National Mortgage Corporation	National Housing Mortgage Association Act of 1934, section 303(f) (12 USC 1718(f)). No limit.
Bank's own stock	12 USC 83. Shares of the bank's own stock may not be acquired or taken as security for loans, except as necessary to prevent loss from a debt previously contracted in good faith. Stock so acquired must be disposed of within six months of the date of acquisition.
Corporate stock acquired through debt previously contracted (DPC) transaction	Case law has established that stock of any corporation debt may be acquired to prevent loss from a debt previously contracted in good faith. See <i>Oppenheimer v. Harriman National Bank &amp; Trust Co. of the City of New York</i> , 301 US 206 (1937). However, if the stock is not disposed of within a reasonable time period, it loses its status as a DPC transaction and becomes a prohibited holding under 12 USC 24(7).
Operations subsidiaries	12 CFR 250.141. Permitted if the subsidiary is to perform, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly.

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

1. Section 208.2(d) of Regulation H defines "capital stock and surplus" to mean tier 1 and tier 2 capital included in a member bank's risk-based capital and the balance of a member bank's allowance for loan and lease losses *not included in its tier 2 capital for calculation of risk-based capital*, based on the bank's most recent consolidated Report of Condition and Income. Section 9 of the Federal Reserve Act (12 USC 338a) provides that the Board has the authority

under this law to approve public-welfare or other such investments, up to the sum of 5 percent of paid-in and unimpaired capital stock and 5 percent of unimpaired surplus, unless the Board determines by order that the higher amount will pose no significant risk to the affected deposit insurance fund, and the bank is adequately capitalized. In no case may the aggregate of such investments exceed 10 percent of the bank's combined capital stock and surplus.

## LIMITED EQUITY INVESTMENTS

Investing in the equity of nonfinancial companies and lending to private-equity-financed companies (that is, companies financed by private equity) have emerged as increasingly important sources of earnings and business relationships at a number of banking organizations (BOs). In this guidance, the term *private equity* refers to shared-risk investments outside of publicly quoted securities and also covers activities such as venture capital, leveraged buyouts, mezzanine financing, and holdings of publicly quoted securities obtained through these activities. While private equity securities can contribute substantially to earnings, these activities can give rise to

increased volatility of both earnings and capital. The supervisory guidance in SR-00-9 on private equity investments and merchant banking activities is concerned with a BO's proper risk-focused management of its private equity investment activities so that these investments do not adversely affect the safety and soundness of the affiliated insured depository institutions.

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

elements in the prudent conduct of these activities.

## Legal and Regulatory Authority

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

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

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

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

<sup>1f</sup>. For additional stock holdings that state member banks are authorized to hold, see table 4.

ownership, middle-market business expansions, and mergers and acquisitions.

## Oversight by the Board of Directors and Senior Management

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

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

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

## Management of the Investment Process

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

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

### *Policies and Limits*

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

strategies should identify limits on hedged exposures and permissible hedging instruments.

### *Procedures*

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

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

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

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

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

The evaluation of existing and potential investments in private equity funds should

involve an assessment of the adequacy of a fund's structure. Consideration should be given to the (1) management fees, (2) carried interest and its computation on an aggregate portfolio basis,<sup>1g</sup> (3) sufficiency of capital commitments that are provided by the general partners in providing management incentives, (4) contingent liabilities of the general partner, (5) distribution policies and wind-down provisions, and (6) performance benchmarks and return-calculation methodologies.

- *Investment-risk ratings.*

Internal risk ratings should assign each investment a rating based on factors such as the nature of the company, strength of management, industry dynamics, financial condition, operating results, expected exit strategies, market conditions, and other pertinent factors. Different rating factors may be appropriate for indirect investments and direct investments.

- *Periodic and timely investment strategy and performance (best, worst, and probable case assessment) reviews of equity investments, conducted at the individual and portfolio levels.*

Management should ensure that periodic and timely review of the institution's equity investments takes place at both individual-investment and portfolio levels. Depending on the size, complexity, and risk profile of the investment, reviews should, when appropriate, include factors such as—

- the history of the investment, including the total funds approved;
- commitment amounts, principal-cash-investment amounts, cost basis, carrying value, major-investment cash flows, and supporting information including valuation rationales and methodologies;
- the current actual percentage of ownership in the portfolio company on both a diluted and undiluted basis;
- a summary of recent events and current outlook;
- the recent financial performance of portfolio companies, including summary compilations of performance and forecasts, historical financial results, current and future plans, key performance metrics, and other relevant items;

- internal investment-risk ratings and rating-change triggers;
- exit strategies, both primary and contingent, and expected internal rates of return upon exit; and
- other pertinent information for assessing the appropriateness, performance, and expected returns of investments.

Portfolio reviews should include an aggregation of individual investment-risk and performance ratings; an analysis of appropriate industry, sector, geographic, and other pertinent concentrations; and total portfolio valuations. Portfolio reports that contain the cost basis, carrying values, estimated fair values, valuation discounts, and other factors summarizing the status of individual investments are integral tools for conducting effective portfolio reviews. Reports containing the results of all reviews should be available to supervisors for their inspection.

Given the inherent uncertainties in equity investment activities, institutions should include in their periodic reviews consideration of the best case, worst case, and probable case assessments of investment performance. These reviews should evaluate changes in market conditions and the alternative assumptions used to value investments—including expected and contingent exit strategies. Major assumptions used in valuing investments and forecasting performance should be identified. These assessments need not be confined to quantitative analyses of potential losses, but may also include qualitative analyses. The formality and sophistication of investment reviews should be appropriate for the overall level of risk the depository institution incurs from this business line.

- *Assessment of the equity investment valuation and accounting policies and the procedures used, their impact on earnings, and the extent of their compliance with generally accepted accounting principles (GAAP).*

Valuation and accounting policies and procedures can have a significant impact on the earnings of institutions engaged in equity investment activities. Many equity investments are made in privately held companies, for which independent price quotations are either unavailable or not available in sufficient volume to provide meaningful liquidity or a market valuation. Valuations of some equity investments may involve a high degree of judgment on the part of management or the

<sup>1g</sup> The carried interest is the share of a partnership's return that is received by the general partners or investment advisers.

skillful use of peer comparisons. Similar circumstances may exist for publicly traded securities that are thinly traded or subject to resale and holding-period restrictions, or when the institution holds a significant block of a company's shares. It is of paramount importance that an institution's policies and procedures on accounting and valuation methodologies for equity investments be clearly articulated.

Under GAAP, equity investments held by investment companies, held by broker-dealers, or maintained in the trading account are reported at fair value, with any unrealized appreciation or depreciation included in earnings and flowing to tier 1 capital. For some holdings, fair value may reflect adjustments for liquidity and other factors.

Equity investments that are not held in investment companies, by broker-dealers, or in the trading account and that have a readily determinable fair value (quoted market price) are generally reported as available-for-sale (AFS). They are marked to market with unrealized appreciation or depreciation recognized in GAAP-defined "comprehensive income" but not earnings. Appreciation or depreciation flows to equity, but, for regulatory capital purposes only, depreciation is included in tier 1 capital.<sup>1h</sup> Equity investments without readily determinable fair values generally are held at cost, subject to write-downs for impairments to the value of the asset. Impairments of value should be promptly and appropriately recognized and written down.

In determining fair value, the valuation methodology plays a critical role. Formal valuation and accounting policies should be established for investments in public companies; direct private investments; indirect fund investments; and, where appropriate, other types of investments with special characteristics. When establishing valuation policies, institutions should consider market conditions, taking account of lockout provisions, the restrictions of Securities and Exchange Commission Rule 144, liquidity features, the dilutive effects of warrants and options, and industry characteristics and dynamics.

<sup>1h</sup>. Under the risk-based capital rule, supplementary (tier 2) capital may include up to 45 percent of pretax unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on AFS equity securities with readily determinable fair values.

Accounting and valuation of equity investments should be subject to regular periodic review. In all cases, valuation reviews should produce documented audit trails that are available to supervisors and auditors. These reviews should assess the consistency of the methodologies used in estimating fair value.

Accounting and valuation treatments should be assessed in light of their potential for abuse, such as through the inappropriate management or manipulation of reported earnings on equity investments. For example, high valuations may produce overstatements of earnings through gains and losses on investments reported at "fair value." On the other hand, inappropriately understated valuations can provide vehicles for smoothing earnings by recognizing gains on profitable investments when an institution's earnings are otherwise under stress. While reasonable people may disagree on valuations given to illiquid private equity investments, institutions should have rigorous valuation procedures that are applied consistently.

Increasingly, equity investments are contributing to an institution's earnings. The potential impact of these investments on the composition, quality, and sustainability of overall earnings should be appropriately recognized and assessed by both management and supervisors.

- *A review of assumed and actual equity-investment exit strategies and the extent of their impact on the returns and reported earnings.*

The principal means of exiting an equity investment in a privately held company include initial public stock offerings, sales to other investors, and share repurchases. An institution's assumptions on exit strategies can significantly affect the valuation of the investment. Management should periodically review investment exit strategies, with particular focus on larger or less-liquid investments.

- *Policies and procedures governing the sale, exchange, transfer, or other disposition of equity investments.*

Policies and procedures to govern the sale, exchange, transfer, or other disposition of the institution's investments should state clearly the levels of management or board approval required for the disposition of investments.

- *Internal methods for allocating capital based on the risk inherent in the equity investment activities, including the methods for identify-*



*ing all material risks and their potential impact on the safety and soundness of the institution.*

Consistent with SR-99-18, depository institutions that are conducting material equity investment activities should have internal methods for allocating economic capital. These methods should be based on the risk inherent in the equity investment activities, including the identification of all material risks and their potential impact on the institution. Organizations that are substantially engaged in these investment activities should have strong capital positions supporting their equity investments. The economic capital that organizations allocate to their equity investments should be well in excess of the current regulatory minimums applied to lending activities. The amount of percentage of capital dedicated to the equity investment business line should be appropriate to the size, complexity, and financial condition of the institution. Assessments of capital adequacy should cover not only the institution's compliance with regulatory capital requirements and the quality of regulatory capital, but should also include an institution's methodologies for internally allocating economic capital to this business line.

## Internal Controls

An adequate system of internal controls, with appropriate checks and balances and clear audit trails, is critical to conducting equity investment activities effectively. Appropriate internal controls should address all the elements of the investment-management process. The internal controls should focus on the appropriateness of existing policies and procedures; adherence to policies and procedures; and the integrity and adequacy of investment valuations, risk identification, regulatory compliance, and management reporting. Any departures from policies and procedures should be documented and reviewed by senior management, and this documentation should be available for examiner review.

As with other financial activities, the assessments of an organization's compliance with both written and implied policies and procedures should be independent of line decision-making functions to the fullest extent possible. When fully independent reviews are not pos-

sible in smaller, less-complex institutions, alternative checks and balances should be established. These alternatives may include random internal audits, reviews by senior management who are independent of the function, or the use of outside third parties.

## Documentation

Documentation of key elements of the investment process, including initial due diligence, approval reviews, valuations, and dispositions, is an integral part of any private equity investment internal control system. This documentation should be accessible to supervisors.

## Legal Compliance

An institution's internal controls should focus on compliance with all federal laws and regulations that are applicable to the institution's investment activities. Regulatory compliance requirements, in particular, should be incorporated into internal controls so managers outside of the compliance or legal functions understand the parameters of permissible investment activities.

To ensure compliance with federal securities laws, institutions should establish policies, procedures, and other controls addressing insider trading. A "restricted list" of securities for which the institution has inside information is one example of a widely used method for controlling the risk of insider trading. In addition, control procedures should be in place to ensure that appropriate reports are filed with functional regulators.

The limitations in sections 23A and 23B of the FRA, which deal with transactions between a depository institution and its affiliates, are presumed by the Gramm-Leach-Bliley Act (GLB Act) to apply to certain transactions between a depository institution and any portfolio company in which an affiliate of the institution owns at least a 15 percent equity interest. This ownership threshold is lower than the ordinary definition of an affiliate, which is typically 25 percent.

## Compensation

Often, key employees in the private equity investment units of banking organizations may

co-invest in the direct or fund investments made by the unit. These co-investment arrangements can be an important incentive and risk-control technique, and they can help to attract and retain qualified management. However, “cherry picking,” or selecting only certain investments for employee participation while excluding others, should be discouraged.

The employees’ co-investment may be funded through loans from the depository institution or its affiliates, which, in turn, would hold a lien against the employees’ interests. The administration of the compensation plan should be appropriately governed pursuant to formal agreements, policies, and procedures. Among other matters, policies and procedures should address the terms and conditions of employee loans and the sales of participants’ interests before the release of the lien.

## Disclosure of Equity Investment Activities

Given the important role that market discipline plays in controlling risk, institutions should ensure that they adequately disclose the information necessary for the markets to assess the institution’s risk profile and performance in this business line. Indeed, it is in the institution’s interest, as well as that of its creditors and shareholders, to publicly disclose information about earnings and risk profiles. Institutions are encouraged to disclose in public filings information on the type and nature of investments, portfolio concentrations, returns, and their contributions to reported earnings and capital. Supervisors should fully review and use these disclosures, as well as periodic regulatory reports filed by publicly held banking organizations, as part of the information they review routinely. The following topics are relevant for public disclosure, though disclosures on each of these topics may not be appropriate, relevant, or sufficient in every case:

- the size of the portfolio
- the types and nature of investments (for example, direct or indirect, domestic or international, public or private, equity or debt with conversion rights)
- initial cost, carrying value, and fair value of investments and, when applicable, comparisons to publicly quoted share values of portfolio companies

- the accounting techniques and valuation methodologies, including key assumptions and practices affecting valuation and changes in those practices
- the realized gains (or losses) arising from sales and unrealized gains (or losses)
- insights regarding the potential performance of equity investments under alternative market conditions

## Lending to or Engaging in Other Transactions with Portfolio Companies

Additional risk-management issues may arise when a depository institution or an affiliate lends to or has other business relationships with (1) a company in which the depository institution or an affiliate has invested (that is, a portfolio company), (2) the general partner or manager of a private equity fund that has also invested in a portfolio company, or (3) a private-equity-financed company in which the banking institution does not hold a direct or indirect ownership interest but which is an investment or portfolio company of a general partner or fund manager with which the banking organization has other investments. Given the potentially higher-than-normal risk attributes of these lending relationships, institutions should devote special attention to ensuring that the terms and conditions of such relationships are at arm’s length and are consistent with the lending policies and procedures of the institution. Similar issues may arise in the context of derivatives transactions with or guaranteed by portfolio companies and general partners. Lending and other business transactions between an insured depository institution and a portfolio company that meet the definition of an affiliate must be negotiated on an arm’s-length basis, in accordance with section 23B of the FRA.

When a depository institution lends to a private-equity-financed company in which it has no equity interest but in which the borrowing company is a portfolio investment of private equity fund managers or general partners with which the institution may have other private-equity-related relationships, care must be taken to ensure that the extension of credit is conducted on reasonable terms. In some cases, lenders may wrongly assume that the general partners or another third party implicitly guar-

antees or stands behind such credits. Reliance on implicit guarantees or comfort letters should not substitute for reliance on a sound borrower that is expected to service its debt with its own resources. As with any type of credit extension, absent a written contractual guarantee, the credit quality of a private equity fund manager, general partner, or other third party should not be used to upgrade the internal credit-risk rating of the borrower company or to prevent the classification or special mention of a loan.

When an institution lends to a portfolio company in which it has a direct or an indirect interest, implications arise under sections 23A and 23B of the FRA, which govern credit-related transactions and asset purchases between a depository institution and its affiliates. Section 23A applies to transactions between a depository institution and any company in which the institution's holding company or shareholders own at least 25 percent of the company's voting shares. The GLB Act extends this coverage by establishing a presumption that a portfolio company is an affiliate of a depository institution if the financial holding company (FHC) uses the merchant banking authority of the GLB Act to own or control more than 15 percent of the equity of the company. Institutions should obtain the assistance of counsel in determining whether such issues exist or would exist if loans were extended to a portfolio company, general partner, or manager. Supervisors, including examiners, should ensure that the institution has conducted a proper review of these issues to avoid violations of law or regulations.

## EVALUATING RISK MANAGEMENT AND INTERNAL CONTROLS

Examiners are expected to conduct an adequate evaluation of the risk-management process used to acquire and manage the securities and derivative contracts used in nontrading activities. In conducting this analysis, examiners should evaluate the following four key elements of a sound risk-management process:

- active board and senior management oversight
- adequate risk-management policies and limits
- appropriate risk-measurement and reporting systems
- comprehensive internal controls

This section identifies basic factors that examiners should consider in evaluating these elements for investment and end-user activities; it reiterates and supplements existing guidance and directives on the use of these instruments for nontrading purposes as provided in various supervisory letters and examination manuals.<sup>2</sup>

In evaluating an institution's risk-management process, examiners should consider the nature and size of its holdings. Examiner judgment plays a key role in assessing the adequacy of an institution's risk-management process for securities and derivative contracts. Examiners should focus on evaluating an institution's understanding of the risks involved in the instruments it holds. Regardless of any responsibility, legal or otherwise, assumed by a dealer or counterparty for a particular transaction, the acquiring insti-

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2. Existing policies and examiner guidance on various supervisory topics applicable to securities and off-balance-sheet instruments can be found in this manual, and the *Bank Holding Company Supervision Manual*, as well as in various supervision and regulation (SR) letters, including SR-90-16, "Implementation of Examination Guidelines for the Review of Asset Securitization Activities"; SR-91-4, "Inspection of Investment-Adviser Subsidiaries of Bank Holding Companies"; SR-93-69, "Risk Management and Internal Controls for Trading Activities"; and SR-98-12, "FFIEC Policy Statement on Investment Securities and End-User Derivatives Activities."

tution is ultimately responsible for understanding and managing the risks of the transactions into which it enters. Failure of an institution to adequately understand, monitor, and evaluate the risks involved in its securities or derivative positions, either through lack of internal expertise or inadequate outside advice, constitutes an unsafe and unsound banking practice.

As with all risk-bearing activities, institutions should fully support the risk exposures of non-trading activities with adequate capital. Banking organizations should ensure that their capital positions are sufficiently strong to support all the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities. In evaluating the adequacy of an institution's capital, examiners should consider any unrecognized net depreciation or appreciation in an institution's securities and derivative holdings. Further consideration should also be given to the institution's ability to hold these securities and thereby avoid recognizing losses.

## Board of Directors and Senior Management Oversight

Active oversight by the institution's board of directors and relevant senior management is critical to a sound risk-management process. Examiners should ensure that these individuals are aware of their responsibilities and that they adequately perform their appropriate roles in overseeing and managing the risks associated with nontrading activities involving securities and derivative instruments.

### *Board of Directors*

The board of directors has the ultimate responsibility for the level of risk taken by the institution. Accordingly, the board should approve overall business strategies and significant policies that govern risk taking, including those involving securities and derivative contracts. In particular, the board should approve policies identifying managerial oversight and articulating risk tolerances and exposure limits for securities and derivative activities. The board should also actively monitor the performance and risk profile of the institution and its various securities and derivative portfolios. Directors should

periodically review information that is sufficiently detailed and timely to allow them to understand and assess the credit, market, and liquidity risks facing the institution as a whole and its securities and derivative positions in particular. These reviews should be conducted at least quarterly and more frequently when the institution holds significant positions in complex instruments. In addition, the board should periodically reevaluate the institution's business strategies and significant risk-management policies and procedures, placing special emphasis on the institution's financial objectives and risk tolerances. The minutes of board meetings and accompanying reports and presentation materials should clearly demonstrate the board's fulfillment of these basic responsibilities. The section of this guidance on managing specific risks provides guidance on the types of objectives, risk tolerances, limits, and reports that directors should consider.

The board of directors should also conduct and encourage discussions between its members and senior management, as well as between senior management and others in the institution, on the institution's risk-management process and risk exposures. Although it is not essential for board members to have detailed technical knowledge of these activities, if they do not, it is their responsibility to ensure that they have adequate access to independent legal and professional advice on the institution's securities and derivative holdings and strategies. The familiarity, technical knowledge, and awareness of directors and senior management should be commensurate with the level and nature of an institution's securities and derivative positions. Accordingly, the board should be knowledgeable enough or have access to independent advice to evaluate recommendations presented by management or investment advisors.

### *Senior Management*

Senior management is responsible for ensuring that there are adequate policies and procedures for conducting investment and end-user activities on both a long-range and day-to-day basis. Management should maintain clear lines of authority and responsibility for acquiring instruments and managing risk, setting appropriate limits on risk taking, establishing adequate systems for measuring risk, setting acceptable standards for valuing positions and measuring per-

formance, establishing effective internal controls, and enacting a comprehensive risk-reporting and risk-management review process. To provide adequate oversight, management should fully understand the institution's risk profile, including that of its securities and derivative activities. Examiners should review the reports to senior management and evaluate whether they provide both good summary information and sufficient detail to enable management to assess the sensitivity of securities and derivative holdings to changes in credit quality, market prices and rates, liquidity conditions, and other important risk factors. As part of its oversight responsibilities, senior management should periodically review the organization's risk-management procedures to ensure that they remain appropriate and sound. Senior management should also encourage and participate in active discussions with members of the board and with risk-management staff regarding risk measurement, reporting, and management procedures.

Management should ensure that investment and end-user activities are conducted by competent staff whose technical knowledge and experience is consistent with the nature and scope of the institution's activities. There should be sufficient depth in staff resources to manage these activities if key personnel are not available. Management should also ensure that back-office and financial-control resources are sufficient to manage and control risks effectively.

### *Independence in Managing Risks*

The process of measuring, monitoring, and controlling risks within an institution should be managed as independently as possible from those individuals who have the authority to initiate transactions. Otherwise, conflicts of interest could develop. The nature and extent of this independence should be commensurate with the size and complexity of an institution's securities and derivative activities. Institutions with large and complex balance sheets or with significant holdings of complex instruments would be expected to have risk managers or risk-management functions fully independent of the individuals who have the authority to conduct transactions. Institutions with less complex holdings should ensure that there is some mechanism for independently reviewing both the level of risk exposures created by securities and deriva-

tive holdings and the adequacy of the process used in managing those exposures. Depending on the size and nature of the institution, this review function may be carried out by either management or a board committee. Regardless of size and sophistication, institutions should ensure that back-office, settlement, and transaction-reconciliation responsibilities are conducted and managed by personnel who are independent of those initiating risk-taking positions.

### *Policies, Procedures, and Limits*

Institutions should maintain written policies and procedures that clearly outline their approach for managing securities and derivative instruments. These policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and general willingness to take risks. They should identify relevant objectives, constraints, and guidelines for both acquiring instruments and managing portfolios. In doing so, policies should establish a logical framework for limiting the various risks involved in an institution's securities and derivative holdings. Policies should clearly delineate lines of responsibility and authority over securities and derivative activities. They should also provide for the systematic review of products new to the firm. Examiners should evaluate the adequacy of an institution's risk-management policies and procedures in relation to its size, its sophistication, and the scope of its activities.

### *Specifying Objectives*

Institutions can use securities and derivative instruments for several primary and complementary purposes.<sup>3</sup> Banking organizations should articulate these objectives clearly and identify the types of securities and derivative contracts to be used for achieving them. Objectives also should be identified at the appropriate portfolio and institutional levels. These objectives should guide the acquisition of individual instruments

3. Such purposes include, but are not limited to, generating earnings, creating funding opportunities, providing liquidity, hedging risk exposures, taking risk positions, modifying and managing risk profiles, managing tax liabilities, and meeting pledging requirements.

and provide benchmarks for periodically evaluating the performance and effectiveness of an institution's holdings, strategies, and programs. Whenever multiple objectives are involved, management should identify the hierarchy of potentially conflicting objectives.

### *Identifying Constraints, Guidelines, and Limits*

An institution's policies should clearly articulate the organization's risk tolerance by identifying its willingness to take the credit, market, and liquidity risks involved in holding securities and derivative contracts. A statement of authorized instruments and activities is an important vehicle for communicating these risk tolerances. This statement should clearly identify permissible instruments or instrument types and the purposes or objectives for which the institution may use them. The statement also should identify permissible credit quality, market-risk sensitivity, and liquidity characteristics of the instruments and portfolios used in nontrading activities. For example, in the case of market risk, policies should address the permissible degree of price sensitivity and/or effective maturity volatility, taking into account an instrument's or portfolio's option and leverage characteristics. Specifications of permissible risk characteristics should be consistent with the institution's overall credit-, market-, and liquidity-risk limits and constraints, and should help delineate a clear set of institutional limits for use in acquiring specific instruments and managing portfolios. Limits can be specified either as guidelines within the overall policies or in management operating procedures. Further guidance on managing specific risks and on the types of constraints and limits an institution might use in managing the credit, market, and liquidity risk of securities and derivative contracts is provided later in this section.

Limits should be set to guide acquisition and ongoing management decisions, control exposures, and initiate discussion within the organization about apparent opportunities and risks. Although procedures for establishing limits and operating within them may vary among institutions, examiners should determine whether the organization enforces its policies and procedures through a clearly identified system of risk limits. The organization's policies should also include specific guidance on the resolution of

limit excesses. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to approved policies.

Limits should implement the overall risk tolerances and constraints articulated in general policy statements. Depending on the nature of an institution's holdings and its general sophistication, limits can be identified for individual business units, portfolios, instrument types, or specific instruments. The level of detail of risk limits should reflect the characteristics of the institution's holdings, including the types of risk to which the institution is exposed. Regardless of their specific form or level of aggregation, limits should be consistent with the institution's overall approach to managing various types of risks. They should also be integrated to the fullest extent possible with institution-wide limits on the same risks as they arise in other activities of the firm. Later in this section, specific examiner considerations for evaluating the policies and limits used in managing each of the various types of risks involved in nontrading securities and derivative activities are addressed.

### *New-Product Review*

An institution's policies should also provide for effective review of any products being considered that would be new to the firm. An institution should not acquire a meaningful position in a new instrument until senior management and all relevant personnel (including those in internal-control, legal, accounting, and auditing functions) understand the product and can integrate it into the institution's risk-measurement and control systems. An institution's policies should define the terms "new product" and "meaningful position" consistent with its size, complexity, and sophistication. Institutions should not be hesitant to define an instrument as a new product. Small changes in the payment formulas or other terms of relatively simple and standard products can greatly alter their risk profiles and justify designation as a new product. New-product reviews should analyze all of the relevant risks involved in an instrument and assess how well the product or activity achieves specified objectives. New-product reviews also should include a description of the relevant accounting guidelines and identify the procedures for mea-

suring, monitoring, and controlling the risks involved.

### *Accounting Guidelines*

The accounting systems and procedures used for general-purpose financial statements and regulatory reporting purposes are critically important to enhancing the transparency of an institution's risk profile. Accordingly, an institution's policies should provide clear guidelines on accounting for all securities and derivative holdings. Accounting treatment should be consistent with specified objectives and with the institution's regulatory requirements. Furthermore, institutions should ensure that they designate each cash or derivative contract for accounting purposes consistent with appropriate accounting policies and requirements. Accounting for non-trading securities and OBS derivative contracts should reflect the economic substance of the transactions. When instruments are used for hedging purposes, the hedging rationale and performance criteria should be well documented. Management should reassess these designations periodically to ensure that they remain appropriate.

### **Risk-Measurement and Reporting Systems**

Clear procedures for measuring and monitoring risks are the foundation of a sound risk-management process. Examiners should ensure that an institution sufficiently integrates these functions into its ongoing management process and that relevant personnel recognize their role and understand the instruments held.

#### *Risk Measurement*

An institution's system for measuring the credit, market, liquidity, and other risks involved in cash and derivative contracts should be as comprehensive and accurate as practicable. The degree of comprehensiveness should be commensurate with the nature of the institution's holdings and risk exposures. Exposures to each type of risk (that is, credit, market, liquidity) should be aggregated across securities and derivative contracts and integrated with similar

exposures arising from lending and other business activities to obtain the institution's overall risk profile.

Examiners should evaluate whether the risk measures and the risk-measurement process are sufficient to accurately reflect the different types of risks facing the institution. Institutions should establish clear risk-measurement standards for both the acquisition and ongoing management of securities and derivative positions. Risk-measurement standards should provide a common framework for limiting and monitoring risks and should be understood by relevant personnel at all levels of the institution—from individual managers to the board of directors.

*Acquisition standards.* Institutions conducting securities and derivative activities should have the capacity to evaluate the risks of instruments before acquiring them. Before executing any transaction, an institution should evaluate the instrument to ensure that it meets the various objectives, risk tolerances, and guidelines identified by the institution's policies. Evaluations of the credit-, market-, and liquidity-risk exposures should be clearly and adequately documented for each acquisition. Documentation should be appropriate for the nature and type of instrument; relatively simple instruments would probably require less documentation than instruments with significant leverage or option characteristics.

Institutions with significant securities and derivative activities are expected either to conduct in-house preacquisition analyses or use specific third-party analyses that are independent of the seller or counterparty. Analyses provided by the originating dealer or counterparty should be used only when a clearly defined investment advisory relationship exists. Less active institutions with relatively uncomplicated holdings may use risk analyses provided by the dealer only if the analyses are derived using standard industry calculators and market conventions. Such analyses must comprehensively depict the potential risks involved in the acquisition, and they should be accompanied by documentation that sufficiently demonstrates that the acquirer understands fully both the analyses and the nature of the institution's relationship with the provider of these analyses. Notwithstanding information and analyses obtained from outside sources, management is ultimately responsible for understanding the nature and



risk profiles of the institution's securities and derivative holdings.

When reviewing an instrument, it is a prudent practice for institutions to obtain and compare price quotes and risk analyses from more than one dealer before acquisition. Institutions should ensure that they clearly understand the responsibilities of any outside parties that provide analyses and price quotes. If analyses and price quotes provided by dealers are used, institutions should assume that each party deals at arm's length for its own account unless a written agreement stating otherwise exists. Institutions should exercise caution when dealers limit the institution's ability to show securities or derivative contract proposals to other dealers to receive comparative price quotes or risk analyses. As a general sound practice, unless the dealer or counterparty is also acting under a specific investment advisory relationship, an investor or end-user should not acquire an instrument or enter into a transaction if its fair value or the analyses required to assess its risk cannot be determined through a means that is independent of the originating dealer or counterparty.

*Portfolio-management standards.* Institutions should periodically review the performance and effectiveness of instruments, portfolios, and institutional programs and strategies. This review should be conducted at least quarterly and should evaluate the extent to which the institution's securities and derivative holdings meet the various objectives, risk tolerances, and guidelines established by the institution's policies.<sup>4</sup> Institutions with large or highly complex holdings should conduct reviews more frequently.

For internal measurements of risk, effective measurement of the credit, market, and liquidity risks of many securities and derivative contracts requires mark-to-market valuations. Accordingly, the periodic revaluation of securities and derivative holdings is an integral part of an effective risk-measurement system. Periodic revaluations should be fully documented. When available, actual market prices should be used. For less liquid or complex instruments, institutions with only limited holdings may use properly documented periodic prices and analyses

provided by dealers or counterparties. More active institutions should conduct periodic revaluations and portfolio analyses using either in-house capabilities or outside-party analytical systems that are independent of sellers or counterparties. Institutions should recognize that indicative price quotes and model revaluations may differ from the values at which transactions can be executed.

*Stress testing.* Analyzing the credit, market, and liquidity risk of individual instruments, portfolios, and the entire institution under a variety of unusual and stressful conditions is an important aspect of the risk-measurement process. Management should seek to identify the types of situations, or the combinations of credit and market events, that could produce substantial losses or liquidity problems. Typically, management considers the institution's consolidated exposures when managing nontrading securities and derivative contracts; therefore, the effect of stress on these exposures should be reviewed. Stress tests should evaluate changes in market conditions, including alternatives in the underlying assumptions used to value instruments. All major assumptions used in stress tests should be identified.

Stress tests should not be limited to quantitative exercises that compute potential losses or gains, but should include qualitative analyses of the tools available to management to deal with various scenarios. Contingency plans outlining operating procedures and lines of communication, both formal and informal, are important products of such qualitative analyses.

The appropriate extent and sophistication of an institution's stress testing depend heavily on the scope and nature of its securities and derivative holdings and on its ability to limit the effect of adverse events. Institutions holding securities or derivative contracts with complex credit, market, or liquidity risk profiles should have an established regime of stress testing. Examiners should consider the circumstances at each institution when evaluating the adequacy or need for stress-testing procedures.

### *Risk Reporting*

An accurate, informative, and timely management information system is essential. Examiners should evaluate the adequacy of an institution's monitoring and reporting of the risks, returns,

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4. For example, the performance of instruments and portfolios used to meet objectives for tax-advantaged earnings should be evaluated to ensure that they meet the necessary credit-rating, market-sensitivity, and liquidity characteristics established for this objective.



and overall performance of security and derivative activities to senior management and the board of directors. Management reports should be frequent enough to provide the responsible individuals with adequate information to judge the changing nature of the institution's risk profile and to evaluate compliance with stated policy objectives and constraints.

Management reports should translate measured risks from technical and quantitative formats to formats that can be easily read and understood by senior managers and directors, who may not have specialized and technical knowledge of all financial instruments used by the institution. Institutions should ensure that they use a common conceptual framework for measuring and limiting risks in reports to senior managers and directors. These reports should include the periodic assessment of the performance of appropriate instruments or portfolios in meeting their stated objective, subject to the relevant constraints and risk tolerances.

### *Management Evaluation and Review*

Management should regularly review the institution's approach and process for managing risks. This includes regularly assessing the methodologies, models, and assumptions used to measure risks and limit exposures. Proper documentation of the elements used in measuring risks is essential for conducting meaningful reviews. Limits should be compared with actual exposures. Reviews should also consider whether existing measures of exposure and limits are appropriate in view of the institution's holdings, past performance, and current capital position.

The frequency of the reviews should reflect the nature of an institution's holdings and the pace of market innovations in measuring and managing risks. At a minimum, institutions with significant activities in complex cash or derivative contracts should review the underlying methodologies of the models they use at least annually—and more often as market conditions dictate—to ensure that they are appropriate and consistent. Reviews by external auditors or other qualified outside parties, such as consultants with expertise in highly technical models and risk-management techniques, may often supplement these internal evaluations. Institutions depending on outside parties to provide various risk-measurement capabilities should ensure that the outside institution has personnel with the

necessary expertise to identify and evaluate the important assumptions incorporated in the risk-measurement methodologies it uses.

### **Comprehensive Internal Controls and Audit Procedures**

Institutions should have adequate internal controls to ensure the integrity of the management process used in investment and end-user activities. Internal controls consist of procedures, approval processes, reconciliations, reviews, and other mechanisms designed to provide a reasonable assurance that the institution's risk-management objectives for these activities are achieved. Appropriate internal controls should address all of the various elements of the risk-management process, including adherence to policies and procedures, the adequacy of risk identification, and risk measurement and reporting.

An important element of a bank's internal controls for investment and end-user activities is comprehensive evaluation and review by management. Management should ensure that the various components of the bank's risk-management process are regularly reviewed and evaluated by individuals who are independent of the function they are assigned to review. Although procedures for establishing limits and for operating within them may vary among banks, management should conduct periodic reviews to determine whether the organization complies with its investment and end-user risk-management policies and procedures. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to the process described in approved policies. Periodic reviews of the risk-management process should also address any significant changes in the nature of instruments acquired, limits, and internal controls that have occurred since the last review.

Examiners should also review the internal controls of all key activities involving securities and derivative contracts. For example, for transaction recording and processing, examiners should evaluate and assess adherence to the written policies and procedures for recording transactions. They should also analyze the transaction-processing cycle to ensure the integrity and accuracy of the institution's records and management reports. Examiners should review

all significant internal controls associated with the management of the credit, market, liquidity, operational, and legal risks involved in securities and derivative holdings.

The examiner should review the frequency, scope, and findings of any independent internal and external auditors relative to the institution's securities and derivative activities. When applicable, internal auditors should audit and test the risk-management process and internal controls periodically. Internal auditors are expected to have a strong understanding of the specific products and risks faced by the organization. In addition, they should have sufficient expertise to evaluate the risks and controls of the institution. The depth and frequency of internal audits should increase if weaknesses and significant issues exist or if portfolio structures, modeling methodologies, or the overall risk profile of the institution has changed.

In reviewing risk management of nontrading securities and derivative activities, internal auditors should thoroughly evaluate the effectiveness of the internal controls used for measuring, reporting, and limiting risks. Internal auditors should also evaluate compliance with risk limits and the reliability and timeliness of information reported to the institution's senior management and board of directors, as well as the independence and overall effectiveness of the institution's risk-management process. The level of confidence that examiners place in an institution's audit programs, the nature of the audit findings, and management's response to those findings will influence the scope of the current examination of securities and derivative activities.

Examiners should pay special attention to significant changes in the nature of instruments acquired, risk-measurement methodologies, limits, and internal controls that have occurred since the last examination. Significant changes in earnings from securities and derivative contracts, in the size of positions, or in the value-at-risk associated with these activities should also receive attention during the examination.

## Evaluating Management of Specific Risks

Specific considerations in evaluating the key elements of sound risk-management systems as they relate to the credit, market, liquidity, oper-

ating, and legal risks involved in securities and derivative contracts for nontrading activities are described below.

### *Credit Risk*

Broadly defined, credit risk is the risk that an issuer or counterparty will fail to perform on an obligation to the institution. The policies of an institution should recognize credit risk as a significant risk posed by the institution's securities and derivative activities. Accordingly, policies should identify credit-risk constraints, risk tolerances, and limits at the appropriate instrument, portfolio, and institutional levels. In doing so, institutions should ensure that credit-risk constraints are clearly associated with specified objectives. For example, credit-risk constraints and guidelines should be defined for instruments used to meet pledging requirements, generate tax-advantaged income, hedge positions, generate temporary income, or meet any other specifically defined objective.

As a matter of general policy, an institution should not acquire securities or derivative contracts until it has assessed the creditworthiness of the issuer or counterparty and determined that the risk exposure conforms with its policies. The credit risk arising from these positions should be incorporated into the overall credit-risk profile of the institution to the fullest extent possible. Given the interconnectedness of the various risks facing the institution, organizations should also evaluate the effect of changes in issuer or counterparty credit standing on an instrument's market and liquidity risk. As a matter of policy, the board of directors and responsible senior management should be informed of the institution's total credit-risk exposures at least quarterly.

*Selection of securities dealers.* In managing their credit risk, institutions also should consider settlement and presettlement credit risk. The selection of dealers, investment bankers, and brokers is particularly important in managing these risks effectively. An institution's policies should identify criteria for selecting these organizations and list all approved firms. The approval process should include a review of each firm's financial statements and an evaluation of its ability to honor its commitments. An inquiry into the general reputation of the dealer is also appropriate. The board of directors or a committee thereof should set limits on the

amounts and types of transactions authorized for each firm. They should also periodically review and reconfirm the list of authorized dealers, investment bankers, and brokers.

The management of a depository institution should have sufficient knowledge about the securities firms and personnel with whom they are doing business. A depository institution should not engage in securities transactions with any securities firm that is unwilling to provide complete and timely disclosure of its financial condition. Management should review the securities firm's financial statements and evaluate the firm's ability to honor its commitments both before entering into transactions with the firm and periodically thereafter. An inquiry into the general reputation of the dealer also is necessary. The board of directors or an appropriate committee of the board should periodically review and approve a list of securities firms with whom management is authorized to do business. The board or an appropriate committee thereof should also periodically review and approve limits on the amounts and types of transactions to be executed with each authorized securities firm. Limits to be considered should include dollar amounts of unsettled trades, safekeeping arrangements, repurchase transactions, securities lending and borrowing, other transactions with credit risk, and total credit risk with an individual dealer.

At a minimum, depository institutions should consider the following in selecting and retaining a securities firm:

- the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by their capital strength, liquidity, and operating results (This evidence should be gathered from current financial data, annual reports, credit reports, and other sources of financial information.)
- the dealer's general reputation or financial stability and its fair and honest dealings with customers (Other depository institutions that have been or are currently customers of the dealer should be contacted.)
- information available from state or federal securities regulators and securities industry self-regulatory organizations, such as the Financial Industry Regulatory Authority (FINRA), concerning any formal enforcement actions against the dealer, its affiliates, or associated personnel

- in those instances when the institution relies on the advice of a dealer's sales representative, the experience and expertise of the sales representative with whom business will be conducted

In addition, the board of directors (or an appropriate committee of the board) must ensure that the depository institution's management has established appropriate procedures to obtain and maintain possession or control of securities purchased. Purchased securities and repurchase-agreement collateral should only be left in safekeeping with selling dealers when (1) the board of directors or an appropriate committee thereof is completely satisfied as to the credit-worthiness of the securities dealer and (2) the aggregate market value of securities held in safekeeping is within credit limitations that have been approved by the board of directors (or an appropriate committee of the board) for unsecured transactions (see the October 22, 1985, FFIEC policy statement "Repurchase Agreements of Depository Institutions with Securities Dealers and Others").

State lending limits generally do not extend to the safekeeping arrangements described above. Notwithstanding this general principle, a bank's board of directors should establish prudent limits for safekeeping arrangements. These prudential limits generally involve a fiduciary relationship, which presents operational rather than credit risks.

To avoid concentrations of assets or other types of risk, banking organizations should, to the extent possible, try to diversify the firms they use for safekeeping arrangements. Further, while certain transactions with securities dealers and safekeeping custodians may entail only operational risks, other transactions with these parties may involve credit risk that could, under some limited circumstances, be subject to statutory lending limits, depending on applicable state laws. If certain transactions are deemed subject to a state's legal lending limit statute because of a particular safekeeping arrangement, the provisions of the state's statutes would, of course, control the extent to which the safekeeping arrangement complies with an individual state's legal lending limit.

*Limits.* An institution's credit policies should also include guidelines on the quality and quantity of each type of security that may be held. Policies should provide credit-risk diversifica-

tion and concentration limits, which may define concentrations to a single or related issuer or counterparty, in a geographical area, or in obligations with similar characteristics. Policies should also include procedures, such as increased monitoring and stop-loss limits, for addressing deterioration in credit quality.

Sound credit-risk management requires that credit limits be developed by personnel who are independent of the acquisition function. In authorizing issuer and counterparty credit lines, these personnel should use standards that are consistent with those used for other activities conducted within the institution and with the organization's overall policies and consolidated exposures. To assess the creditworthiness of other organizations, institutions should not rely solely on outside sources, such as standardized ratings provided by independent rating agencies, but should perform their own analysis of a counterparty's or issuer's financial strength. In addition, examiners should review the credit-approval process to ensure that the credit risks of specific products are adequately identified and that credit-approval procedures are followed for all transactions.

For most cash instruments, credit exposure is measured as the current carrying value. In the case of many derivative contracts, especially those traded in OTC markets, credit exposure is measured as the replacement cost of the position, plus an estimate of the institution's potential future exposure to changes in the replacement value of that position in response to market price changes. Replacement costs of derivative contracts should be determined using current market prices or generally accepted approaches for estimating the present value of future payments required under each contract, at current market rates.

The measurement of potential future credit-risk exposure for derivative contracts is more subjective than the measurement of current exposure and is primarily a function of the time remaining to maturity; the number of exchanges of principal; and the expected volatility of the price, rate, or index underlying the contract. Potential future exposure can be measured using an institution's own simulations or, more simply, by using add-ons such as those included in the Federal Reserve's risk-based capital guidelines. Regardless of the method an institution uses, examiners should evaluate the reasonableness of the assumptions underlying the institution's risk measure.

For derivative contracts and certain types of cash transactions, master agreements (including netting agreements) and various credit enhancements (such as collateral or third-party guarantees) can reduce settlement, issuer, and counterparty credit risk. In such cases, an institution's credit exposures should reflect these risk-reducing features only to the extent that the agreements and recourse provisions are legally enforceable in all relevant jurisdictions. This legal enforceability should extend to any insolvency proceedings of the counterparty. Institutions should be prepared to demonstrate sufficient due diligence in evaluating the enforceability of these contracts.

In reviewing credit exposures, examiners should consider the extent to which positions exceed credit limits and whether exceptions are resolved according to the institution's adopted policies and procedures. Examiners should also evaluate whether the institution's reports adequately provide all personnel involved in the acquisition and management of financial instruments with relevant, accurate, and timely information about the credit exposures and approved credit lines.

### *Market Risk*

Market risk is the exposure of an institution's financial condition to adverse movements in the market rates or prices of its holdings before such holdings can be liquidated or expeditiously offset. It is measured by assessing the effect of changing rates or prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution. Although many banking institutions focus on carrying values and reported earnings when assessing market risk at the institutional level, other measures focusing on total returns and changes in economic or fair values better reflect the potential market-risk exposure of institutions, portfolios, and individual instruments. Changes in fair values and total returns directly measure the effect of market movements on the economic value of an institution's capital and provide significant insights into their ultimate effects on the institution's long-term earnings. Institutions should manage and control their market risks using both an earnings and an economic-value approach, and at least on an economic or fair-value basis.

When evaluating capital adequacy, examiners should consider the effect of changes in market rates and prices on the economic value of the institution by evaluating any unrealized losses in an institution's securities or derivative positions. This evaluation should assess the ability of the institution to hold its positions and function as a going concern if recognition of unrealized losses would significantly affect the institution's capital ratios. Examiners also should consider the impact that liquidating positions with unrealized losses may have on the institution's prompt-corrective-action capital category.

Market-risk limits should be established for both the acquisition and ongoing management of an institution's securities and derivative holdings and, as appropriate, should address exposures for individual instruments, instrument types, and portfolios. These limits should be integrated fully with limits established for the entire institution. At the institutional level, the board of directors should approve market-risk exposure limits that specify percentage changes in the economic value of capital and, when applicable, in the projected earnings of the institution under various market scenarios. Similar and complementary limits on the volatility of prices or fair value should be established at the appropriate instrument, product-type, and portfolio levels, based on the institution's willingness to accept market risk. Limits on the variability of effective maturities may also be desirable for certain types of instruments or portfolios.

The scenarios an institution specifies for assessing the market risk of its securities and derivative products should be sufficiently rigorous to capture all meaningful effects of any options. For example, in assessing interest-rate risk, scenarios such as 100, 200, and 300 basis point parallel shifts in yield curves should be considered as well as appropriate nonparallel shifts in structure to evaluate potential basis, volatility, and yield curve risks.

Accurately measuring an institution's market risk requires timely information about the current carrying and market values of its securities and derivative holdings. Accordingly, institutions should have market-risk measurement systems commensurate with the size and nature of these holdings. Institutions with significant holdings of highly complex instruments should ensure that they have independent means to value their positions. Institutions using internal models to measure risk should validate the

models according to the standards in SR-11-7. This should include a periodic review of all elements of the modeling process, including its assumptions and risk-measurement techniques. Institutions relying on third parties for market-risk measurement systems and analyses should fully understand the assumptions and techniques used by the third party.

Institutions should evaluate the market-risk exposures of their securities and derivative positions and report this information to their boards of directors regularly, not less frequently than each quarter. These evaluations should assess trends in aggregate market-risk exposure and the performance of portfolios relative to their established objectives and risk constraints. They also should identify compliance with board-approved limits and identify any exceptions to established standards. Examiners should ensure that institutions have mechanisms to detect and adequately address exceptions to limits and guidelines. Examiners should also determine that management reporting on market risk appropriately addresses potential exposures to basis risk, yield curve changes, and other factors pertinent to the institution's holdings. In this connection, examiners should assess an institution's compliance with broader guidance for managing interest-rate risk in a consolidated organization.

Complex and illiquid instruments often involve greater market risk than broadly traded, more liquid securities. Often, this higher potential market risk arising from illiquidity is not captured by standardized financial-modeling techniques. This type of risk is particularly acute for instruments that are highly leveraged or that are designed to benefit from specific, narrowly defined market shifts. If market prices or rates do not move as expected, the demand for these instruments can evaporate. When examiners encounter such instruments, they should review how adequately the institution has assessed its potential market risks. If the risks from these instruments are material, the institution should have a well-documented process for stress testing their value and liquidity assumptions under a variety of market scenarios.

### *Liquidity Risk*

Banks face two types of liquidity risk in their securities and derivative activities: risks related to specific products or markets and risks related to the general funding of their activities. The

former, market-liquidity risk, is the risk that an institution cannot easily unwind or offset a particular position at or near the previous market price because of inadequate market depth or disruptions in the marketplace. The latter, funding-liquidity risk, is the risk that the bank will be unable to meet its payment obligations on settlement dates. Since neither type of liquidity risk is unique to securities and derivative activities, management should evaluate these risks in the broader context of the institution's overall liquidity.

When specifying permissible securities and derivative instruments to accomplish established objectives, institutions should take into account the size, depth, and liquidity of the markets for specific instruments, and the effect these characteristics may have on achieving an objective. The market liquidity of certain types of instruments may make them entirely inappropriate for achieving certain objectives. Moreover, institutions should consider the effects that market risk can have on the liquidity of different types of instruments. For example, some government-agency securities may have embedded options that make them highly illiquid during periods of market volatility and stress, despite their high credit rating. Accordingly, institutions should clearly articulate the market-liquidity characteristics of instruments to be used in accomplishing institutional objectives.

The funding risk of an institution becomes a more important consideration when its unrealized losses are material; therefore, this risk should be a factor in evaluating capital adequacy. Institutions with weak liquidity positions are more likely to be forced to recognize these losses and suffer declines in their accounting and regulatory capital. In extreme cases, these effects could force supervisors to take prompt corrective actions.

Examiners should assess whether the institution adequately considers the potential liquidity risks associated with the liquidation of securities or the early termination of derivative contracts. Many forms of standardized contracts for derivative transactions allow counterparties to request collateral or terminate their contracts early if the institution experiences an adverse credit event or a deterioration in its financial condition. In addition, under situations of market stress, customers may ask for the early termination of some contracts within the context of the dealer's market-making activities. In these circumstances, an institution that owes

money on derivative transactions may be required to deliver collateral or settle a contract early, possibly at a time when the institution may face other funding and liquidity pressures. Early terminations may also open additional, unintended market positions. Management and directors should be aware of these potential liquidity risks and address them in the institution's liquidity plan and in the broader context of the institution's liquidity-management process. In their reviews, examiners should consider the extent to which such potential obligations could present liquidity risks to the institution.

### *Operating and Legal Risks*

Operating risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Some specific sources of operating risk include inadequate procedures, human error, system failure, or fraud. Inaccurately assessing or controlling operating risks is one of the more likely sources of problems facing institutions involved in securities and derivative activities.

Adequate internal controls are the first line of defense in controlling the operating risks involved in an institution's securities and derivative activities. Of particular importance are internal controls to ensure that persons executing transactions are separated from those individuals responsible for processing contracts, confirming transactions, controlling various clearing accounts, approving the accounting methodology or entries, and performing revaluations.

Institutions should have approved policies, consistent with legal requirements and internal policies, that specify documentation requirements for transactions and formal procedures for saving and safeguarding important documents. Relevant personnel should fully understand the requirements. Examiners should also consider the extent to which institutions evaluate and control operating risks through internal audits, stress testing, contingency planning, and other managerial and analytical techniques.

An institution's operating policies should establish appropriate procedures to obtain and maintain possession or control of instruments purchased. Institutions should ensure that transactions consummated orally are confirmed as soon as possible. As noted earlier in this section, banking organizations should, to the extent pos-

sible, seek to diversify the firms used for their safekeeping arrangements to avoid concentrations of assets or other types of risk.

Legal risk is the risk that contracts are not legally enforceable or documented correctly. This risk should be limited and managed through policies developed by the institution's legal counsel. At a minimum, guidelines and processes should be in place to ensure the enforceability of counterparty agreements. Examiners should determine whether an institution is adequately evaluating the enforceability of its agreements before individual transactions are consummated. Institutions should also ensure that the counterparty has sufficient authority to enter into the transaction and that the terms of the agreement are legally sound. Institutions should further ascertain that their netting agreements are adequately documented, have been executed properly, and are enforceable in all relevant jurisdictions. Institutions should know relevant tax laws and interpretations governing the use of netting instruments.

An institution's policies should also provide conflict-of-interest guidelines for employees who are directly involved in purchasing securities from and selling securities to securities dealers on behalf of their institution. These guidelines should ensure that all directors, officers, and employees act in the best interest of the institution. The board of directors may wish to adopt policies prohibiting these employees from engaging in personal securities transactions with the same securities firms the institution uses without the specific prior approval of the board. The board of directors may also wish to adopt a policy applicable to directors, officers, and employees that restricts or prohibits them from receiving gifts, gratuities, or travel expenses from approved securities dealer firms and their personnel.

## INTERNATIONAL DIVISION INVESTMENTS

The same types of instruments exist in international banking as in domestic banking. Securities and derivative contracts may be acquired by a bank's international division and overseas branches for its own account, and foreign equity investments may be held by the bank directly or through Edge Act corporations. The investments held by most international divisions are predomi-

nately securities issued by various governmental entities of the countries in which the bank's foreign branches are located. These investments are held for a variety of purposes:

- They are required by various local laws.
- They are used to meet foreign reserve requirements.
- They result in reduced tax liabilities.
- They enable the bank to use new or increased re-discount facilities or benefit from greater deposit or lending authorities.
- They are used by the bank as an expression of "goodwill" toward a country.

The examiner should be familiar with the applicable sections of Regulation K (12 CFR 211) governing a member bank's international investment holdings, as well as other regulations discussed in this section. Because of the mandatory investment requirements of some countries, securities held cannot always be as "liquid" and "readily marketable" as required in domestic banking. However, the amount of a bank's "mandatory" holdings will normally be a relatively small amount of its total investments or capital funds.

A bank's international division may also hold securities strictly for investment purposes; these are expected to provide a reasonable rate of return commensurate with safety considerations. As with domestic investment securities, the bank's safety must take precedence, followed by liquidity and marketability. Securities held by international divisions are considered to be liquid if they are readily convertible into cash at their approximate carrying value. They are marketable if they can be sold in a very short time at a price commensurate with yield and quality. Speculation in marginal foreign securities to generate more favorable yields is an unsound banking practice and should be discouraged.

Banks are generally prohibited from investing in stocks. However, a number of exceptions (detailed earlier in this section) are often applicable to the international division. For example, the bank may, under section 24A of the Federal Reserve Act (12 USC 371d), hold stock in overseas corporations that hold title to foreign bank premises. Both stock and other securities holdings are permissible under certain circumstances and in limited amounts under section 211.4 of Regulation K—Permissible Activities and Investments of Foreign Branches of



Member Banks (12 CFR 211). Other sections of Regulation K permit the bank to make equity investments in Edge Act and agreement corporations and in foreign banks, subject to certain limitations.

Standard & Poor's, Moody's, and other publications from U.S. rating-services rate Canadian and other selected foreign securities that are authorized for U.S. commercial bank investment purposes under 12 USC 24(7). However, in many other countries, securities-rating services are limited or nonexistent. When they do exist, the ratings are only indicative and should be supplemented with additional information on legality, credit soundness, marketability, and foreign-exchange and country-risk factors. The opinions of local attorneys are often the best source of determining whether a particular foreign security has the full faith and credit backing of a country's government.

Sufficient analytical data must be provided to the bank's board of directors and senior management so they can make informed judgments about the effectiveness of the international division's investment policy and procedures. The institution's international securities and derivative contracts should be included on all board and senior management reports detailing domestic securities and derivative contracts received. These reports should be timely and sufficiently detailed to allow the board of directors and senior management to understand and assess the credit, market, and liquidity risks facing the institution and its securities and derivative positions.

## MORTGAGE-DERIVATIVE PRODUCTS

Some mortgage-derivative products exhibit considerably more price volatility than mortgages or ordinary mortgage pass-through securities. If not managed in a safe and sound manner, these products can expose investors to significant risk of loss. The price volatility of these products is caused in part by the uncertain cash flows that result from changes in the prepayment rates of the underlying mortgages.

Mortgage-derivative products are complex; a high degree of technical expertise is required to understand how their prices and cash flows may behave in various interest-rate and prepayment scenarios. Moreover, the secondary market for

some of these products can be relatively thin, making them difficult to liquidate if the need arises. Finally, new variants of these instruments continue to be introduced, whose price performance under varying market and economic conditions has not been tested.

Under the February 10, 1992, supervisory policy statement of the Federal Financial Institutions Examination Council (FFIEC), the banking agencies call for special management of mortgage-derivative products. A general principle underlying this policy is that mortgage-derivative products possessing average life or price volatility in excess of a benchmark fixed-rate 30-year mortgage-backed pass-through security are high-risk mortgage securities and are not suitable investments. All high-risk mortgage securities (defined later in this section) acquired by depository institutions after February 10, 1992, must be carried in the institution's trading account or as assets available for sale. Mortgage-derivative products that do not meet the definition of a high-risk mortgage security at the time of purchase may be reported as held-to-maturity, available-for-sale, or held-for-trading, as appropriate. Institutions must ascertain at least annually whether such products have become high-risk mortgage securities. Purchases of high-risk mortgage securities before February 10, 1992, generally will be reviewed in accordance with previously existing supervisory policies.

Institutions generally should hold mortgage-derivative products that meet the definition of a high-risk mortgage security only to reduce interest-rate risk, in accordance with safe and sound practices. Before taking a position in any high-risk mortgage security, an institution should conduct an analysis to ensure that the position will reduce its overall interest-rate risk. Furthermore, depository institutions that purchase high-risk mortgage securities must demonstrate that they understand and are effectively managing the risks associated with these instruments. First, a depository institution must determine whether a mortgage-derivative product is high risk before purchasing it. A prospectus supplement or other supporting analysis that fully details the cash flows covering each of the securities held by the institution should be obtained and analyzed before purchase and retained for examiner review. In any event, a prospectus supplement should be obtained as soon as it becomes available. Levels of activity involving high-risk mortgage securities should be reasonably related to



an institution's capital, capacity to absorb losses, and level of in-house management sophistication and expertise. Appropriate managerial and financial controls must be in place, and the institution must analyze, monitor, and prudently adjust its holdings of high-risk mortgage securities to correspond with changing price and maturity expectations.

An institution should consider the liquidity and price volatility of high-risk mortgage securities before purchasing them. In certain circumstances, the appropriate federal regulatory authority may deem an institution's purchase or retention of high-risk mortgage securities to be contrary to safe and sound practices for depository institutions, which will result in criticism by examiners. Examiners may require the orderly divestiture of high-risk mortgage securities. Securities and other products with risk characteristics similar to those of high-risk mortgage securities, whether carried on or off the balance sheet (such as CMO swaps, but excluding servicing assets), will be subject to the same supervisory treatment as high-risk mortgage securities.

## High-Risk Mortgage Securities

In general, any mortgage-derivative product that exhibits greater price volatility than a benchmark fixed-rate 30-year mortgage-backed pass-through security will be deemed to be high risk. For purposes of the FFIEC policy statement, a high-risk mortgage security is defined as any mortgage-derivative product that at the time of purchase, or at a subsequent testing date, meets any of the following tests. (In general, a mortgage-derivative product that does not meet any of the three tests below will be considered to be a non-high-risk mortgage security.)

- *Average-life test.* The mortgage-derivative product has an expected weighted average life greater than 10.0 years.
- *Average-life sensitivity test.* The expected weighted average life of the mortgage-derivative product—
  - extends by more than 4.0 years, assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points or

- shortens by more than 6.0 years, assuming an immediate and sustained parallel shift in the yield curve of minus 300 basis points.

- *Price-sensitivity test.* The estimated change in the price of the mortgage-derivative product is more than 17 percent, due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

In applying any of the above tests, all of the underlying assumptions (including prepayment assumptions) for the underlying collateral must be reasonable. All of the assumptions underlying the analysis must be available for examiner review. For example, if an institution's prepayment assumptions differ significantly from the median prepayment assumptions of several major dealers as selected by examiners, the examiners may use these median prepayment assumptions to determine if a particular mortgage-derivative product is high risk. The above tests may be adjusted to consider significant movements in market interest rates, to fairly measure the risk characteristics of new mortgage-backed products, and to take appropriate action to prevent circumvention of the definition of a high-risk mortgage security and other such standards.

Generally, a CMO floating-rate debt class will not be subject to the average-life and average-life sensitivity tests described above if it bears a rate that, at the time of purchase or at a subsequent testing date, is below the contractual cap on the instrument. (An institution may purchase interest-rate contracts that effectively uncap the instrument.) For purposes of this guidance, a CMO floating-rate debt class is a debt class whose rate adjusts at least annually on a one-for-one basis with the debt class's index. The index must be a conventional, widely used market-interest-rate index such as the London Interbank Offered Rate (LIBOR). Inverse floating-rate debt classes are not included in the definition of a floating-rate debt class.

### *Holdings of High-Risk Mortgage Securities*

An institution generally may only acquire a high-risk mortgage-derivative product to reduce its overall interest-rate risk. (Institutions meeting the previously discussed guidance on the use of these securities in a trading account may

also purchase these securities for trading purposes.) An institution that has acquired high-risk mortgage securities to reduce interest-rate risk needs to frequently assess its interest-rate risk position and the performance of these securities. Since interest-rate positions constantly change, an institution may determine that its high-risk mortgage securities no longer reduce interest-rate risk. Therefore, mortgage-derivative products that are high risk when acquired shall not be reported as held-to-maturity securities at amortized cost.

In appropriate circumstances, examiners may seek the orderly divestiture of high-risk mortgage securities that do not reduce interest-rate risk. Appropriate circumstances are those in which the examiner determines that continued ownership of high-risk mortgage securities represents an undue safety-and-soundness risk to the institution. This risk can arise from (1) the size of a bank's or thrift's holdings of high-risk mortgage securities in relation to its capital and earnings, (2) management's inability to demonstrate an understanding of the nature of the risks inherent in the securities, (3) the absence of internal monitoring systems and other internal controls to appropriately measure the market and cash-flow risks of these securities, (4) management's inability to prudently manage its overall interest-rate risk, or (5) similar factors.

An institution that owns or plans to acquire high-risk mortgage securities must have a monitoring and reporting system in place to evaluate their expected and actual performance. Institutional analysis must show that the proposed acquisition of a high-risk mortgage security will reduce overall interest-rate risk. After purchase, the institution must evaluate at least quarterly whether the high-risk mortgage security has actually reduced interest-rate risk.

Analyses performed before the purchase of high-risk mortgage securities, and subsequent analyses, must be fully documented and will be subject to examiner review. This review will include an analysis of all management assumptions about the interest-rate risk associated with the institution's assets, liabilities, and off-balance-sheet positions. Analyses performed and records constructed to justify purchases on a post-acquisition basis are unacceptable and will be subject to examiner criticism. Reliance on analyses and documentation obtained from a securities dealer or other outside party without

internal analyses by the institution are unacceptable, and reliance on these third-party analyses will be subject to examiner criticism.

Management should also maintain documentation demonstrating it took reasonable steps to ensure that the prices paid for high-risk mortgage securities represented fair market value. Generally, price quotes should be obtained from at least two brokers before executing a trade. If price quotes cannot be obtained from more than one broker, management should document those reasons (such as the unique or proprietary nature of the transaction). In addition, a depository institution that owns high-risk mortgage securities must demonstrate that it has established the following:

- a board-approved portfolio policy that addresses the goals and objectives the institution expects to achieve through its securities activities, including objectives for interest-rate risk reduction with respect to high-risk mortgage securities
- limits on the amounts of funds that may be committed to high-risk mortgage securities
- specific financial-officer responsibility for and authority over securities activities involving high-risk mortgage securities
- adequate information systems
- procedures for periodic evaluation of high-risk mortgage securities and their actual performance in reducing interest-rate risk
- appropriate internal controls

The board of directors or an appropriate committee thereof and the institution's senior management should regularly (at least quarterly) review all high-risk mortgage securities to determine whether they are adequately satisfying the objectives for interest-rate risk reduction set forth in the portfolio policy. The depository institution's senior management should be fully knowledgeable about the risks associated with prepayments and their subsequent impact on its high-risk mortgage securities. Failure to comply with this policy will be viewed as an unsafe and unsound practice.

## Non-High-Risk Mortgage Securities

Mortgage-derivative products that do not meet the definition of high-risk mortgage securities at the time of purchase should be reported as

held-to-maturity, available-for-sale, or held-for-trading, as appropriate. Institutions must ascertain and document before purchase and at least annually thereafter that non-high-risk mortgage securities that are held to maturity remain outside the high-risk category. If an institution is unable to make these determinations through internal analysis, it must use information derived from a source that is independent of the party from whom the product is being purchased. Standard industry calculators used in the mortgage-related securities marketplace are acceptable and considered independent sources. If relying on this type of independent analysis, institutions are responsible for ensuring that the assumptions underlying the analysis and the resulting calculation are reasonable. Documentation verifying this determination will be subject to examiner review.

A mortgage-derivative product that was not a high-risk mortgage security when it was purchased as an investment may later fall into the high-risk category. When this occurs, the depository institution may continue to designate the mortgage-derivative product as held-to-maturity, providing that management intends and is able to hold the security to maturity. Furthermore, examiners should consider any unrecognized net depreciation in held-to-maturity high-risk securities when the adequacy of the depository institution's capital adequacy is evaluated.

Once a mortgage-derivative product has been designated as high risk, it may be redesignated as nonhigh risk only if, at the end of two consecutive quarters, it does not meet the definition of a high-risk mortgage security. Upon redesignation as a non-high-risk security, it does not need to be tested for another year.

## UNSUITABLE INVESTMENT PRACTICES

Institutions should categorize each of their security activities as trading, available-for-sale, or held-to-maturity consistent with GAAP (that is, Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities," as amended) and regulatory reporting standards. Management should reassess the categorizations of its securities periodically to ensure that they remain appropriate.

Securities that are intended to be held principally for the purpose of selling in the near term should be classified as trading assets. Trading activity includes the active and frequent buying and selling of securities for the purpose of generating profits on short-term fluctuations in price. Securities held for trading purposes must be reported at fair value, with unrealized gains and losses recognized in current earnings and regulatory capital. The proper categorization of securities is important to ensure that trading gains and losses are promptly recognized—which will not occur when securities intended to be held for trading purposes are categorized as held-to-maturity or available-for-sale.

It is an unsafe and unsound practice to report securities held for trading purposes as available-for-sale or held-to-maturity securities. A close examination of an institution's actual securities activities will determine whether securities it reported as available-for-sale or held-to-maturity are, in reality, held for trading. When the following securities activities are conducted in available-for-sale or held-to-maturity accounts, they should raise supervisory concerns. The first five practices below are considered trading activities and should not occur in available-for-sale or held-to-maturity securities portfolios, and the sixth practice is wholly unacceptable under all circumstances.

### Gains Trading

"Gains trading" is the purchase of a security and the subsequent sale of that same security at a profit after a short holding period. However, at the same time, securities acquired for this purpose that cannot be sold at a profit are retained in the available-for-sale or held-to-maturity portfolio; unrealized losses on debt securities in these two categories do not directly affect regulatory capital and are not reported in income until the security is sold. Examiners should note institutions that exhibit a pattern or practice of reporting significant amounts of realized gains on sales of nontrading securities (typically, available-for-sale securities) after short holding periods, while continuing to hold other nontrading securities with significant amounts of unrealized losses. In these situations, examiners may designate some or all of the securities reported outside of the trading category as trading assets.

## When-Issued Securities Trading

“When-issued” securities trading is the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities. A purchaser of a when-issued security acquires all of the risks and rewards of owning a security and may sell this security at a profit before having to take delivery and pay for it.

## Pair-Offs

“Pair-offs” are security purchases that are closed out or sold at, or before, settlement date. In a pair-off, an institution commits to purchase a security. Then, before the predetermined settlement date, the institution will pair off the purchase with a sale of the same security. Pair-offs are settled net when one party to the transaction remits the difference between the purchase and sale price to the counterparty. Other pair-off transactions may involve the same sequence of events using swaps, options on swaps, forward commitments, options on forward commitments, or other off-balance-sheet derivative contracts.

## Extended Settlements

Regular-way settlement for U.S. government and federal-agency securities (except mortgage-backed securities and derivative contracts) is one business day after the trade date. Regular-way settlement for corporate and municipal securities is three business days after the trade date, and settlement for mortgage-backed securities can be up to 60 days or more after the trade date. The use of a settlement period that exceeds the regular-way settlement periods to facilitate speculation is considered a trading activity.

## Short Sales

A short sale is the sale of a security that is not owned. Generally, the purpose of a short sale is to speculate on a fall in the price of the security. Short sales should be conducted in the trading portfolio. A short sale that involves the delivery of the security sold short by borrowing it from the depository institution’s available-for-sale or

held-to-maturity portfolio should not be reported as a short sale. Instead, it should be reported as a sale of the underlying security with gain or loss recognized.

## Adjusted Trading

Adjusted trading involves the sale of a security to a broker or dealer at a price above the prevailing market value and the simultaneous purchase and booking of a different security, frequently a lower-grade issue or one with a longer maturity, at a price above its market value. Thus, the dealer is reimbursed for its losses on the purchase from the institution and ensured a profit. Adjusted-trading transactions inappropriately defer the recognition of losses on the security sold and establish an excessive reported value for the newly acquired security. Consequently, these transactions are prohibited and may be in violation of 18 USC sections 1001 (False Statements or Entries) and 1005 (False Entries).

## ACCOUNTING FOR SECURITIES AND FINANCIAL CONTRACTS

A single class of a financial instrument that can meet trading, investment, or hedging objectives may have a different accounting treatment applied to it, depending on management’s purpose for holding it. Therefore, an examiner reviewing investment or trading activities should be familiar with the different accounting methods to ensure that the particular accounting treatment being used is appropriate for the purpose of holding a financial instrument and the economic substance of the related transaction.

The accounting principles that apply to securities portfolios, including trading accounts, and to off-balance-sheet (OBS) derivative instruments are complex and have evolved over time—both with regard to authoritative standards and related banking practices. The objective of this section is to summarize the major aspects of the accounting principles in this important area to make the accounting guidance for both financial reporting and regulatory reporting purposes understandable and useful to examiners and supervisors. Accordingly, it is not intended to

set forth new accounting policies for investment activities. While this section provides a summary of important accounting principles for financial reporting and regulatory reporting purposes in this area, it does not list or explain the detailed line items of financial reports that must be reported for securities portfolios or OBS derivative instruments in financial reports. Examiners should consult the sources of generally accepted accounting principles (GAAP) and regulatory reporting requirements that are referred to in this section for more detailed guidance in these areas.

Examiners should be aware that accounting practices in foreign countries may differ from the accounting principles followed in the United States. Nevertheless, foreign institutions are required to submit regulatory reports prepared in accordance with U.S. banking agency regulatory reporting instructions, which to a large extent incorporate GAAP. This section will focus on reporting requirements of the United States.

The major topics covered in this section are listed below. The discussion of specific types of balance-sheet instruments (for example, securities) and OBS derivative instruments (for example, swaps, futures, forwards, and options) is interwoven with the discussion of these topic areas:

- overview of the broad framework for accounting for securities portfolios, including the general framework for trading activities
- general framework for OBS derivative instruments, including hedges
- summaries of specific accounting principles for OBS derivative instruments

## Accounting for Securities Portfolios

### *Treatment under FASB Statement No. 115*

In May 1993, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 115, “Accounting for Certain Investments in Debt and Equity Securities.”<sup>5</sup> FASB 115 supersedes FASB 12, “Account-

5. FASB 115 does not apply to investments in equity securities accounted for under the equity method or to investments in consolidated subsidiaries. This statement does not apply to institutions whose specialized accounting practices include accounting for substantially all investments in debt and equity securities at market value or fair value, with changes in value recognized in earnings (income) or in the

ing for Certain Marketable Securities,” and related interpretations. It also amends other standards, including FASB 65, “Accounting for Certain Mortgage-Banking Activities,” to eliminate mortgage-backed securities from that statement’s scope. FASB 115 addresses investments in equity securities that have readily determinable fair values and all investments in debt securities.<sup>6</sup> The accounting standard was effective for fiscal years beginning after December 15, 1993, for regulatory reporting and financial reporting purposes. It was to be initially applied as of the beginning of an institution’s fiscal year and cannot be applied retroactively to prior years’ financial statements. Investments subject to the standard are to be classified in three categories and accounted for as follows:

- *Held-to-maturity account.* Debt securities that the institution has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.
- *Trading account.* Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price.
- *Available-for-sale account.* Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains

change in net assets. Examples of those institutions are brokers and dealers in securities, defined-benefit pension plans, and investment companies.

6. FASB 115 states that the fair value of an equity security is readily determinable if sales prices or bid-asked quotations are currently available on a securities exchange registered with the SEC or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the FINRA Automated Quotations systems or by the National Quotation Bureau, Inc. Restricted stock does not meet that definition.

The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above. The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.



and losses excluded from earnings and reported as a net amount in a separate component of shareholders' equity.

Under FASB 115, mortgage-backed securities that are held for sale in conjunction with mortgage-banking activities should be reported at fair value in the trading account. The standard does not apply to loans, including mortgage loans, that have not been securitized.

Upon the acquisition of a debt or equity security, an institution must place the security into one of the above three categories. At each reporting date, the institution must reassess whether the balance-sheet designation continues to be appropriate. Proper classification of securities is a key examination issue. (See SR-94-25 and SR-93-72; see also SR-96-32.)

FASB 115 recognizes that certain changes in circumstances may cause the institution to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Thus, the sale or transfer of a held-to-maturity security due to one of the following changes in circumstances will not be viewed as inconsistent with its original balance-sheet classification:

- evidence of a significant deterioration in the issuer's creditworthiness
- a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security (but not a change in tax law that revises the marginal tax rates applicable to interest income)
- a major business combination or major disposition (such as the sale of a segment) that necessitates the sale or transfer of held-to-maturity securities to maintain the institution's existing interest-rate risk position or credit risk policy
- a change in statutory or regulatory requirements that significantly modifies either what constitutes a permissible investment or the maximum level of investments in certain kinds of securities, thereby causing an institution to dispose of a held-to-maturity security
- a significant increase by the regulator in the industry's capital requirements that causes the institution to downsize by selling held-to-maturity securities
- a significant increase in the risk weights of

debt securities used for regulatory risk-based capital purposes

Furthermore, FASB 115 recognizes that other events that are isolated, nonrecurring, and unusual for the reporting institution and could not have been reasonably anticipated may cause the institution to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. However, all sales and transfers of held-to-maturity securities must be disclosed in the footnotes to the financial statements.

An institution must not designate a debt security as held-to-maturity if the institution has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be designated as held-to-maturity if the banking organization or other company anticipates that the security would be available to be sold in response to—

- changes in market interest rates and related changes in the security's prepayment risk,
- needs for liquidity (for example, due to the withdrawal of deposits, increased demand for loans, surrender of insurance policies, or payment of insurance claims),
- changes in the availability of and the yield on alternative investments,
- changes in funding sources and terms, or
- changes in foreign-currency risk.

According to FASB 115, an institution's asset-liability management may take into consideration the maturity and repricing characteristics of all investments in debt securities, including those held to maturity or available for sale, without tainting or casting doubt on the standard's criterion that there be a "positive intent to hold until maturity."<sup>7</sup> However, securities should not be designated as held-to-maturity if they may be sold. Further, liquidity can be derived from the held-to-maturity category by

7. In summary, under FASB 115, sales of debt securities that meet either of the following two conditions may be considered as "maturities" for purposes of the balance-sheet classification of securities: (i) The sale of a security occurs near enough to its maturity date (or call date if exercise of the call is probable)—for example, within three months—that interest-rate risk has been substantially eliminated as a pricing factor. (ii) The sale of a security occurs after the institution has already collected at least 85 percent of the principal outstanding at acquisition from either prepayments or scheduled payments.

the use of repurchase agreements that are designated as financings, but not sales.

Transfers of a security between investment categories should be accounted for at fair value. FASB 115 requires that at the date of the transfer, the security's unrealized holding gain or loss must be accounted for as follows:

- For a security transferred from the trading category, the unrealized holding gain or loss at the date of the transfer will have already been recognized in earnings and should not be reversed.
- For a security transferred into the trading category, the unrealized holding gain or loss at the date of the transfer should be recognized in earnings immediately.
- For a debt security transferred into the available-for-sale category from the held-to-maturity category, the unrealized holding gain or loss at the date of the transfer should be recognized in a separate component of shareholders' equity.
- For a debt security transferred into the held-to-maturity category from the available-for-sale category, the unrealized holding gain or loss at the date of the transfer should continue to be reported in a separate component of shareholders' equity but should be amortized over the remaining life of the security as an adjustment of its yield in a manner consistent with the amortization of any premium or discount.

Transfers from the held-to-maturity category should be rare, except for transfers due to the changes in circumstances that were discussed above. Transfers from the held-to-maturity account not meeting the exceptions indicated above may call into question management's intent to hold other securities to maturity. According to the standard, transfers into or from the trading category should also be rare.

FASB 115 requires that institutions determine whether a decline in fair value below the amortized cost for individual securities in the available-for-sale or held-to-maturity accounts is "other than temporary" (that is, whether this decline results from permanent impairment). For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security that was not impaired at acquisition, an other-than-temporary impairment should be considered to have occurred. If the decline in fair value

is judged to be other than temporary, the cost basis of the individual security should be written down to its fair value, and the write-down should be accounted in earnings as a realized loss. This new cost basis should not be written up if there are any subsequent recoveries in fair value.

### *Other Regulatory Reporting Guidance*

As mentioned above, FASB 115 has been adopted for regulatory reporting purposes. In January 1992, the Federal Reserve Board issued a policy statement on securities activities that, among other things, provided supervisory accounting guidance for securities portfolios owned by banks. Elements of this policy statement have been incorporated within this section.

Other supervisory accounting guidance on securities portfolios and related matters is presented in—

- the Federal Reserve Board staff's examination guidelines for asset-securitization activities (specifically, volume 2, which addresses related accounting issues), and
- the Call Report instructions, particularly, the glossary entries on—
  - coupon stripping, treasury securities, and STRIPS;
  - trade fails;
  - foreign debt-exchange transactions;
  - market value of securities;
  - nonaccrual status;
  - premiums and discounts;
  - short positions;
  - sales of assets (see also "participations in pools of residential mortgages" for mortgage-backed securities);
  - trading accounts;
  - trade-date and settlement-date accounting;<sup>8</sup> and
  - when-issued securities.

These sources should be reviewed for more detailed guidance in the above areas involving securities portfolios and related transactions.

8. As described in this glossary entry, for Call Report purposes, the preferred method for reporting securities transactions is recognition on the trade date.

## General Framework for OBS Derivative Instruments

As discussed in the previous subsection, the general accounting framework for securities portfolios divides them into three categories: held-to-maturity (accounted for at amortized cost), available-for-sale (accounted for at fair value, with changes in fair value recorded in equity), and trading (accounted for at fair value, with changes in fair value recorded in earnings). On the other hand, the traditional accounting framework (that is, trading, investment, and held-for-sale) continues to be relevant for loans and other assets that are not in the legal form of a security.

In contrast, the general accounting framework for OBS derivative instruments under GAAP is set forth below:

- If the instrument meets certain specified hedge-accounting criteria, the gains or losses (income or expense) associated with the OBS derivative instrument can be deferred and realized on a basis consistent with the income or expense of the item that is being hedged.
- Otherwise, gains or losses must be recognized as they occur, and OBS derivative instruments generally must be marked to market. Of course, any OBS derivative instruments that are used for trading purposes should be placed in a well-supervised trading account and marked to market.

As discussed more fully below, this general framework is derived from FASB 52, “Foreign-Currency Translation,” and FASB 80, “Accounting for Futures Contracts.” Each statement presents different hedging criteria and related guidance. Furthermore, reporting requirements for the call report differ from GAAP with regard to domestic futures and forward contracts and written options. However, the call report follows GAAP for foreign-currency OBS derivative instruments and interest-rate swaps.

It is important to note that while GAAP permits hedge accounting for OBS derivative instruments, both GAAP and the call report prohibit the use of hedge-accounting treatment for securities (sometimes called “cash-market securities”) or other on-balance-sheet items that may serve as economic hedges of other balance-sheet or OBS items. Thus, even if a security or other balance-sheet instrument would serve the

same purpose as an OBS derivative instrument in effectively hedging an institution’s risk exposures, the gains and losses, or income and expense, on that balance-sheet instrument *cannot* be deferred to a future period when the income or expense on the item being hedged is recognized.

The following addresses important GAAP and call report rules for netting of the assets and liabilities arising from OBS derivative instruments.

## SPECIFIC ACCOUNTING PRINCIPLES FOR OBS DERIVATIVE INSTRUMENTS

### Instruments Covered by Authoritative Accounting Standards

#### *Futures Contracts Not Associated with Foreign-Currency Exposures (“Domestic Futures Contracts”)*

Futures contracts are firm (legally binding) commitments to purchase or sell a particular financial instrument or index, foreign currency, or commodity at a specified future date, quantity, and price or yield. Futures contracts have standardized contractual terms, are traded on organized exchanges, and are typically settled in cash rather than actual delivery.

Under GAAP, all futures contracts, except for foreign-currency futures contracts, should be reported in accordance with FASB 80, “Accounting for Futures Contracts.” Foreign-currency futures contracts should be reported in accordance with the guidance contained in FASB 52, “Foreign-Currency Translation.” These statements should be referred to for more detailed accounting guidance in these areas.

*Treatment of open contracts.* Contracts are outstanding (open) until they have been terminated by either the acquisition or delivery of the underlying financial instruments, or by offset. “Offset” is the purchase and sale of an opposite position using an equal number of futures contracts on the same delivery month executed through the same broker or dealer and executed on the same exchange.

Transactions in futures contracts generally involve a deposit of cash as margin, which will generally be reported within “other assets” on the balance sheet. As discussed below, changes



in the market values of open positions may affect general ledger accounts and related balance-sheet amounts. However, since open positions are executory contracts (firm commitments) for delivery of the underlying financial instrument, the underlying instrument should not be reflected as an asset or liability on the balance sheet.<sup>9</sup> Only when the closing of an open position results in the acquisition or disposition of the underlying financial instrument would an asset be recorded, or removed from, the balance sheet.

As a prudent management measure, all open positions in futures contracts must be reviewed at least monthly (or more often, if material), and their current market values should be determined using published price quotations. These futures positions must be revalued at their current market value on these valuation dates, and any changes in value should be reported in accordance with the guidance presented below for hedge or non-hedge contracts.

*Criteria for hedge-accounting treatment.* If certain criteria are met, the accounting under GAAP for a futures contract that is used to hedge an asset, liability, commitment, or anticipated transaction (“hedged item”) should be similar to the method of accounting for the hedged item. This means that changes in the market value of the futures contract are recognized in income when the related changes in the price or interest rate of the hedged item are recognized. Where an anticipated transaction is the hedged item, the change in value of the futures contract is included in the measurement of the anticipated transaction. Realized gains or losses from changes in the market value of futures contracts that qualify as a hedge of an existing asset or liability should be recognized as an adjustment of the carrying amount (often called “book value”) of the hedged item. A change in the market value of a futures contract that is a hedge of a firm commitment should be included in the measurement of the transaction that satisfies the commitment.

Under FASB 80, a futures contract should be accounted for as a hedge when the following conditions are met:

- The institution must have determined that the item to be hedged (that is, an identifiable asset, liability, firm commitment, or anticipated transaction) will expose it to price or interest-rate risk.
- The futures contract must reduce the exposure to risk. This must be demonstrated at the inception of the hedge by an expectation that changes in the prices of both the contract and the hedged item will be highly correlated. Furthermore, ongoing results must show a high degree of correlation, or the hedge will be considered ineffective and consequently marked to market. In other words, the bank must monitor the price movements of both the hedge contract and the hedged item to determine that it is probable (that is, likely to occur) that the results of the futures contract will offset changes in the market value of the hedged item and that these results have done so from inception to the determination date.
- The futures contract must be designated as a hedge by management at the inception of the hedge.

In order for a futures contract to qualify as a hedge of an anticipated transaction, the following two additional criteria must be met:

- Significant characteristics and expected terms of the anticipated transaction must be identified.
- The occurrence of the anticipated transaction must be probable.<sup>10</sup>

If the criteria for applying hedge-accounting methods have been met, the gain or loss on a futures contract, instead of being currently recognized in income, is an adjustment to the cost of the asset or liability being hedged. The adjustment, then, will be recognized in income when gain or loss on the hedged asset or liability is determined. For example, if the item being hedged is an interest-bearing liability that is reported at amortized cost, the changes in the market value of the futures contract would be reflected as adjustments to the carrying amount (or book value) of the liability. The historical cost of the liability and the adjustments brought about by the hedge would then be amortized in

9. Although the underlying instruments or notional amounts of these commitments are not reported in the balance sheet, they are disclosed in footnotes to the financial statement. For regulatory reporting purposes, open positions in futures contracts are to be reported in the call report, Schedule RC-L.

10. It will be particularly difficult to meet this criteria when an anticipated transaction is not expected to take place in the near future.

interest expense over the expected remaining life of the liability.

If the hedged asset or liability is marked to market, the hedge position will also be marked to market. There is no deferral of gains or losses in this situation; likewise, there is no deferral of gains or losses if the futures contract hedges an anticipated transaction if the asset to be acquired or liability incurred will be reported at fair value.

If a futures contract qualifying as a hedge is closed before the date of the related anticipated transaction, the accumulated change in value of the contract should be carried forward (assuming high correlation has occurred) and included in the measurement of the related transaction. When it becomes probable that the quantity of the anticipated transaction will be less than that originally hedged, a pro rata portion of the futures results that would have been included in the measurement of the transaction should be recognized as a gain or loss.

If high correlation between price changes of the hedged item and the futures position is no longer evident, the bank should discontinue accounting for the futures contracts as a hedge. If this were to occur, the portion of the change in the market value of the contract that has not offset the market-value changes of the hedged item should be reflected in income. The contract should thereafter be accounted for as a non-hedge contract with subsequent changes in the contract's market value reflected in current income. When a futures position that has been an effective hedge is terminated before disposition of the hedged item, the gain or loss on the terminated contracts must be deferred and amortized over the remaining life of the hedged item. If the contracts do not qualify as hedges, the gain or loss is recognized currently in income or expense, as appropriate.

*Call report treatment.* Regulatory reporting standards, as a general rule, do not permit the deferral of gains or losses by banks on domestic futures and forwards, whether or not the contracts are used for hedging purposes. All changes in market value of futures and forward contracts are reported in income in the period they occur. The banking agencies adopted this reporting standard as a supervisory policy before the issuance of FASB 80. As exceptions to the general prohibition, hedge accounting in accordance with FASB 80 is permitted by the three banking agencies only for futures and forward

contracts used to hedge mortgage-banking operations, and those foreign-currency futures contracts that are covered by FASB 52.

### *Foreign-Currency Off-Balance-Sheet Instruments*

The primary source of authoritative guidance for accounting for foreign-currency translations and foreign-currency transactions is FASB 52. The standard encompasses futures contracts, forward agreements, and currency swaps as they relate to foreign-currency hedging.

FASB 52 draws a distinction between foreign-exchange translation and transactions. Translation, generally, focuses on the combining of foreign and domestic entities for presentation in the consolidated financial statements and for reporting these financial statements in one currency. Foreign-currency transactions, in contrast, are transactions (such as purchases or sales) by a business operation in currencies other than its functional currency. For U.S. depository institutions, the functional currency will generally be the dollar for its U.S. operations and will typically be the local currency where its foreign operations transact business.<sup>11</sup>

*Foreign-currency translation.* Translation is the conversion to U.S. dollars of the financial statement of a foreign operation (branch, division, or subsidiary) that is denominated in the operation's functional currency for inclusion in the parent's consolidated financial statements. The foreign operation's balance sheet is translated at the exchange rate in effect on the statement date, and the income statement is translated at an appropriate weighted-average rate for the reporting period. Gains or losses arising from foreign-currency translation are not recognized currently

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11. Detailed guidance of determining the functional currency is set forth in appendix 1 of FASB 52:

"An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. The functional currency of an entity is, in principle, a matter of fact. In some cases, the facts will clearly identify the functional currency; in other cases they will not."

FASB 52 indicates the salient economic indicators, and possibly other factors, that should be considered both individually and collectively when determining the functional currency. These factors include cashflow, price and market sales indicators, expense indicators, financing indicators, and intercompany transactions and arrangements.

in income; instead, they are treated as adjustments to a separate component of equity. Recognition in income of these cumulative foreign-currency adjustments will take place when the foreign operation is either sold or substantially liquidated.

An institution may engage in hedging transactions to reduce the risk of exchange losses on translating its net equity investments in foreign operations for presentation in its financial statements, thus avoiding the consequent volatility in its capital position. The effect of the special hedging treatment is to include the change in value of the hedging instrument as a part of the same separate component of equity as the translation adjustment.

*Foreign-currency transactions.* Gains or losses on foreign-currency transactions, in contrast to translation, are recognized in income as they occur, unless they arise from a qualifying hedge. FASB 52 provides the following guidance about the types of foreign-currency transactions for which gain or loss is not currently recognized in earnings.

Gains and losses on the following foreign-currency transactions should not be included in determining net income but should be reported in the same manner as translation adjustments:

- foreign-currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign entity, commencing as of the designation date
- intercompany foreign-currency transactions that are of a long-term-investment nature (that is, settlement is not planned or anticipated in the foreseeable future), when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting institution's financial statements

In addition to hedges of the balance sheet, a gain or loss on a forward contract or other foreign-currency transaction that is intended to hedge an identifiable foreign-currency commitment (for example, a firm commitment to sell or purchase equipment) should be deferred and included in the measurement of the related foreign-currency transaction (as an adjustment to the revenue or cost of the equipment in the example). If a foreign-currency hedge is terminated before the transaction date of the related commitment, any deferred gain or loss is to remain deferred until recognition of gain or loss

on the items that were hedged occurs. Losses should not be deferred, however, if it is estimated that deferral would lead to recognizing losses in later periods. A foreign-currency transaction should be considered a hedge of an identifiable foreign-currency commitment if both of the following conditions are met:

- The foreign-currency transaction is designated as, and is effective as, a hedge of a foreign-currency commitment.
- The foreign-currency commitment is firm.

Thus, FASB 52 is distinguished from FASB 80 in that hedging the risks from arrangements that have not matured into a firm commitment (that is, an anticipated transaction), such as forecasted foreign sales, do not qualify for hedge treatment. Another dissimilarity between FASB 52 and 80 is that the hedge of a foreign-currency exposure can be considered in isolation; there is no requirement that the overall risk of the institution must be reduced by the hedge as there is under FASB 80. Under the latter accounting standard, an institution is, in effect, required to consider the presence of any natural hedges that may be present in its balance sheet. To illustrate, an institution with foreign-currency-denominated receivables has foreign-exchange risk; however, any accounts payable that are denominated in the same currency as the receivables reduce the overall exposure. Under FASB 52, however, the institution could hedge the gross amount of receivables and qualify for deferring gain or loss recognition. Note, however, that by neutralizing the exposure from the receivables, the institution now has exchange risk equal to its payables position. Thus, gains or losses from a hedge of a foreign-currency risk may be deferred, even though the hedge position may increase the overall foreign-exchange risk of the institution.

To qualify for deferral, a foreign-currency-hedge position is required to be denominated in the same currency as the items it is hedging, unless such a hedge is impracticable. "Impracticable" means there are severe impediments to using the currency, such as illiquidity or a limited exchange market in the currency that is to be hedged, not merely that it is uneconomical. Since the foreign-exchange-hedge position is generally denominated in the same currency as the items that are being hedged, there will be perfect correlation (that is, no basis risk) between the hedged items and the hedge position. There-

fore, ongoing monitoring of the correlation between the foreign-exchange hedge and the hedged items is required only if a substitute or proxy currency is being used.

## Instruments That Are Not Covered by Authoritative Accounting Standards

### *Forward Contracts*

Domestic forward contracts, including forward-rate agreements, are generally accounted for by analogy to the accounting guidance for futures contracts set forth in FASB 80, which is summarized above. As noted above, the accounting for foreign-currency-forward contracts is addressed by FASB 52. Forward-rate agreements denominated in a foreign currency are generally accounted for by analogy to the accounting guidance for forward contracts set forth in FASB 52. Of course, any such instruments that are used for trading purposes should be placed in a well-supervised trading account and marked to market.

### *Interest-Rate Swaps*

Consistent with the general requirement that trading assets or liabilities be marked to market, a dealer or market maker in swap instruments is required to mark its swap trading book to fair value. While the Emerging Issues Task Force (EITF) has provided limited interpretations on interest-rate swaps used as hedges, authoritative standards from the FASB, AICPA, or SEC do not yet exist. In this vacuum, diverse industry practice has resulted. EITF Issue No. 84-7 applies to the early termination of swaps that hedge some financial instrument. According to this issue, gain or loss from early termination is to be deferred and amortized as a yield adjustment to the underlying financial instrument. Issue No. 84-36 applies if there is an underlying debt obligation on the balance sheet of the company entering into a swap. The company should account for the swap like a hedge of the obligation and record interest expense using the revised interest rate. Situations where the swap does not hedge an asset or liability were excluded from the scope of the two issues, other than to note a diversity of accounting treatment. Some accountants view the EITF's discussion of hedging as

guidance for accounting for "synthetic instruments" (for example, the transformation of fixed-rate debt into floating-rate debt by use of an interest-rate swap) where there is no risk reduction per se. Interest-rate swaps denominated in a foreign currency, including cross-currency interest-rate swaps, are generally accounted for by analogy to the accounting guidance set forth in FASB 52. Financial institutions engaging in swaps should have written policies that govern the accounting for these instruments, and should be consistently following these policies.

### *Options*

Options involve two parties: the writer (or seller) and the purchaser (or holder). The purchaser of an option has the right, but not the obligation, to purchase or sell the option's underlying instrument according to the terms specified in the option. The option writer, in return for receiving the option premium, is obligated to perform according to the terms of the option.

### *Purchased Options*

When held as a trading asset, a purchased option is to be marked to market under GAAP for presentation in the financial statements. For regulatory reporting purposes, the call report instructions state that purchased options are generally not to be reported at market value. For call report purposes, the only purchased options that have specifically been permitted to be marked to market are those that have been used for trading purposes and have been placed in a well-supervised trading account.

Purchased options can be an effective hedge of anticipated transactions, where they can be exercised if the anticipated transaction matures into a firm commitment or can be allowed to lapse if the anticipated transaction does not occur. Alternatively, options can be used to protect against unfavorable price movements, but allow the institution to benefit from favorable price changes of the hedged items. Virtually no authoritative literature has been issued for the accounting of options. The AICPA released an issues paper in 1986 that proposed certain methods of accounting for options that included criteria for hedging that were similar to FASB 80.

The paper, however, is not authoritative. One recommendation of the report was to account for purchased options used for hedging purposes in two discrete amounts: (a) the intrinsic value (that is the difference, if positive, between the option's exercise price and the market price of the underlying instrument) and (b) the time value of the option. The former would be an adjustment to determining the gain or loss on exercise or expiration; the latter would be amortized over the term of the option. Another recommendation was that if the option qualifies as a hedge of an item carried at historical cost, changes in intrinsic value would be included in a separate component of equity. While parts of the issues paper have become industry practice, some of the approaches advocated, such as these two examples, are rarely seen.

For presentation in the call report, purchased options that are held for hedging purposes generally are to be recorded at cost and amortized over the term of the option. No periodic valuation for balance-sheet presentation of open positions is permitted.

*Written options.* By their inherent risk profile, written options, whether covered or not, do not generally qualify as a hedge for accounting purposes. The premium received by an option's writer should be deferred until the point at which the option either expires or is exercised. If the option is exercised, the premium is an adjustment to the amount realized on the sale of the underlying obligation. If the option expires out of the money, the premium is considered earned and is reported as other fee income. Options that are in the money (and thus an obligation to the writer) are to be marked to market, according to the SEC.

The call report instructions provide guidance for written "standby contracts," which are a form of option. Standby contracts are to be valued at the lower of cost or market (since the written option is a liability, the absolute amount reported is the higher of cost (the premium received) or market value). Market value in this context is the loss exposure, which would be based on the difference between the option's strike price and the market price of the underlying instrument.

*Purchased options that hedge foreign-exchange exposures related to anticipated transactions.* In issuing guidance on foreign-currency hedges that use options (Issue No. 90-17), the EITF

noted that FASB 52 did not specifically consider options. The EITF used certain elements from FASB 80 in identifying appropriate criteria for applying hedge-accounting treatment: the requirement that overall risk be reduced, that high correlation between the hedge position and the hedged items be present, and that anticipated transactions could be hedged if they are identifiable and probable. This guidance is narrowly applied to strategies using at-the-money options at the inception of the hedge. When it examined other option-based hedge strategies (Issue No. 91-4), the EITF was unable to reach a consensus because of objections by the SEC about the deferral of gains or losses related to anticipated transactions. The SEC also objected to any deferral of losses from written options, since to write options does not, in the SEC's view, reduce risk.

### Netting or Offsetting On- and Off-Balance-Sheet Assets and Liabilities

The FASB issued Interpretation 39 in 1992, which went into effect for 1994 financial statements of banks and other companies. This interpretation applies to the netting of assets and liabilities arising from (i) "traditional" activities, such as loans and deposits, and (ii) OBS derivative instruments. The assets and liabilities from derivatives primarily are their fair value, or estimated market value, and the receivables and payables on these instruments. FIN 39 clarifies the definition of a "right of setoff" that GAAP has long indicated must exist before netting of assets and liabilities can occur in the balance sheet. One of the main purposes of FIN 39 was to clarify that FASB's earlier guidance on netting of assets and liabilities (TB 88-2) applies to amounts recognized for OBS derivative instruments as well.

Balance-sheet items arise from off-balance-sheet interest-rate and foreign-currency instruments primarily in two ways. First, those banking organizations and other companies that trade OBS derivative instruments (for example, interest-rate and currency swaps, forwards, and options) are required by GAAP to mark to market these positions by recording their fair values (estimated market values) on the balance sheet and recording any changes in these fair values (unrealized gains and losses) in earnings. Second, interest-rate and currency swaps have



receivables and payables that accrue over time, reflecting expected cash inflows and outflows that must periodically be exchanged under these contracts, and these receivables and payables must be recorded on the balance sheet as assets and liabilities, respectively.<sup>12</sup>

Under FIN 39, setoff, or the netting of assets and liabilities to a particular counterparty, is not permitted unless all of the following four criteria are met:

- Two parties must owe each other determinable amounts.
- The reporting entity must have a right to set off its obligation with the amount due to it.
- The reporting entity must actually intend to set off these amounts.
- The right of setoff must be enforceable at law.

When all four criteria are met, a bank or other company may offset the related asset and liability and report the net amount in its GAAP financial statements. FIN 39 also indicates, without regard to the third criterion (the parties' intent), the netting of fair values of OBS derivative contracts executed with the counterparty under a legally enforceable master netting agreement is permitted. If any one of the other three criteria is not met, the fair value of contracts in a loss position with the counterparty *cannot* be offset against the fair value of contracts in a gain position with that counterparty, and the organization would be required to record gross unrealized gains on such contracts as assets and gross unrealized losses as liabilities.

### Call Report Requirements

The call report instructions provide guidance on netting for purposes of reporting risk-based capital information.<sup>13</sup> Furthermore, the FFIEC,

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12. In contrast, the notional amounts of off-balance-sheet derivative instruments, or the principal amounts of the underlying asset or assets to which the values of the contracts are indexed, are not recorded on the balance sheet. Note, however, that if the OBS instrument is carried at market value, that value will include any receivable or payable components. Thus, for those OBS instruments that are subject to a master netting agreement, the accrual components in fair value are also netted.

13. The risk-based capital guidelines provide generally that a credit-equivalent amount is calculated for each individual interest-rate and exchange-rate contract. The credit-equivalent amount is determined by summing the positive mark-to-market values of each contract with an estimate of the

on an interim basis, adopted for the call report the provisions of FIN 39 that are applicable to derivative contracts, effective for 1994 call reports. The general instructions to the call report, however, explicitly prohibit the netting of assets and liabilities by banks *unless* specifically required by the instructions. Thus, FIN 39 is not to be applied to traditional balance-sheet assets and liabilities for call report purposes.

## DISCLOSURE FOR SECURITIES AND FINANCIAL CONTRACTS

In addition to issuing authoritative guidance on methods of accounting (that is, how a particular transaction is to be reported on the balance sheet or statements of income or cash flow), the FASB (and SEC) also set standards for minimum disclosure of the financial activities, condition, and other issues that should be incorporated in a company's annual report. Information to meet these disclosure requirements is audited by the company's independent accountants and may be presented either as footnotes to the financial statements or incorporated in management's discussion and analysis (MD&A). In MD&A, management reviews in some detail the company's results from operations, its liquid resources and capital position, significant events occurring after the date of the financial statements, and other matters. MD&A is required for reports filed with the SEC, such as the annual 10-K and quarterly 10-Q. Since it is fixed-form, the call report does not have a direct analogue to MD&A. There is, however, considerable overlap as many of the call report's supporting schedules and memoranda state much of the information required under the disclosure standards of GAAP. The following section briefly describes the GAAP requirements for disclosure relating to financial instruments.

As an interim step in a project to improve the accounting for financial instruments, par-

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potential future credit exposure. The credit-equivalent amount is then assigned to the appropriate risk-weight category.

Netting of swaps and similar contracts is recognized for risk-based capital purposes only when accomplished through "netting by novation." This is defined as a written bilateral contract between two counterparties under which any obligation to each other is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single net amount for the previous gross obligations.

ticularly OBS instruments, the FASB wrote new disclosure standards intended to increase the transparency of contractual terms, risks, and market values of both on- and off-balance-sheet financial instruments. To date, three standards have been written, requiring additional disclosure about instruments having certain risks (including a lack of diversification), the fair market value of financial instruments (including such classes as securities, loans, and deposits), and the discussion of the risk-management strategies when the company uses OBS instruments.

The first standard resulting from the financial instruments project was FASB 105, "Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk." Under the standard, a company is required to describe the notional amounts and significant contractual terms for financial instruments that have off-balance-sheet risk of accounting loss.<sup>14</sup> Secondly, the company is required to disclose the amount of accounting loss that would occur as a result of credit risk.<sup>15</sup> As a part of the disclosure of credit risk, the company is required to discuss its policies for requiring collateral and a description of the collateral or other security supporting the contracts. Lastly, the company is required to report significant credit concentrations across all classes of financial instruments. This may be done by industry, region, or other economic characteristics. FASB 105 was amended by FASB 119 (see below) to require the disclosure of notional amount and significant contract terms of financial instruments without off-balance-sheet risk of loss (for example, purchased options) in addition to the disclosures

described earlier. FASB 105 was required to be followed for annual reports beginning in 1991.

The second standard issued by the FASB was FASB 107, "Disclosures about Fair Value of Financial Instruments," which was effective for the 1993 annual reports of institutions with assets of \$150 million or more and will be effective for the 1996 annual reports of smaller institutions. Under the standard, a company is required to disclose the fair value of virtually all classes of financial instruments. The company should disclose its methods for estimating fair value, such as the use of market quotes or valuation techniques (and disclose the assumptions used if values are estimated) for instruments without active markets. FASB 107 requires that demand deposits be reported at face value and the value of long-term relationships and other intangibles not be taken into account, although these and other nonfinancial assets and liabilities may be separately disclosed. In response to criticisms from industry analysts about the difficulty in following some companies' disclosures, the FASB amended FASB 107 when it issued FASB 119, "Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments." FASB 119 requires that the fair-value disclosure separate OBS instruments used as hedges from the instruments on the balance sheet being hedged. FASB 107 was also amended to require fair-value disclosure in a single place rather than scattered throughout the annual report.

In response to calls for further improvement in the disclosure of derivatives activities, FASB 119 requires a firm that issues or holds derivatives to differentiate in its disclosures between derivatives that it uses for trading purposes and derivatives used for risk-management or other end-user reasons.

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14. An off-balance-sheet accounting loss occurs when there is the potential for loss because of market or credit risks that exceed the amount reported on the balance sheet for the OBS instrument. In other words, the loss in the event of a default or adverse market movement could exceed the reported value of the contract. For example, a purchased-put option does not have accounting risk of loss because the most that could be lost by the holder is the amount of the premium paid (of course, the economic loss would be the fair value of the option). The writer of the put, on the other hand, would have an accounting loss to the writer if it must pay cash to settle the contract in excess of the premium it received. Thus the writer has off-balance-sheet risk of loss while the holder does not.

15. For example, an interest-rate swap accounted for using the accrual method that has a market value of \$1,000 and an accrued net receivable of \$10 has an accounting risk of loss of only \$10.

- *Trading activities.* A dealer is required to report the fair value (both year-end and annual average) of its derivatives positions and to disaggregate derivatives trading profits. This disaggregation may be reported either for derivative instruments alone or broken down by some other method by the firm, such as lines of business, risk exposures (for example, interest-rate or foreign-exchange), or another method as long as trading profits from derivative instruments are disclosed. The FASB encouraged, but did not require, the disclosure of both year-end and average fair values of trading assets and liabilities that are not

derivatives, whether they are financial instruments or nonfinancial items, to give a more comprehensive picture of the firm's trading pursuits.

- *End-user activities.* For derivatives not used in trading, but instead used for hedging or other risk-management purposes, a firm is now required to describe its objectives for using derivatives and discuss its strategies for achieving those objectives. The firm is also required to describe how it reports derivatives in its financial statements as well as give certain details (such as the amount of gains or losses explicitly deferred) about derivatives used to hedge anticipated transactions. The

fair values of end-user derivatives must also be separately disclosed from the fair value of items hedged by the derivatives.

Finally, FASB 119 encourages a firm to disclose quantitative information, consistent with its method for managing risk, that would be useful to financial statement readers in assessing its activities. Suggested approaches include gap analyses, the effect of hypothetical price shocks on reported earnings, and the disclosure of value at risk at the report date and its average during the year. FASB 119 first applied to annual reports for year-end 1994.



# Investment Securities and End-User Activities

## Examination Objectives

Effective date November 1995

Section 2020.2

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1. To determine if policies, practices, procedures, and internal controls regarding investments are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To determine the overall quality of the investment portfolio and how that quality relates to the soundness of the bank.
5. To determine compliance with laws and regulations.
6. To initiate corrective action when policies, practices, procedures or internal controls are deficient or when violations of laws or regulations have been noted.

# Investment Securities and End-User Activities

## Examination Procedures

Effective date November 2004

## Section 2020.3

1. If used, answer the questions in section 2020.4, the “Investment Securities and End-User Activities” internal control questionnaire.
2. On the basis of an evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the following examination procedures. Also, obtain a listing of any deficiencies noted in the latest review conducted by internal or external auditors, and determine if any corrections have been accomplished. Determine the extent and effectiveness of investment-policy supervision by—
  - a. reviewing the abstracted minutes of meetings of the board of directors or appropriate committees;
  - b. determining that proper authorizations have been made for investment officers or committees;
  - c. determining any limitations or restrictions on delegated authorities;
  - d. evaluating the sufficiency of analytical data used by the board or investment committee;
  - e. reviewing the reporting methods used by department supervisors and internal auditors to ensure compliance with established policy; and
  - f. preparing a memo for the examiner who is assigned “Duties and Responsibilities of Directors” and the examiner who is in charge of the international examination, if applicable, stating conclusions on the effectiveness of directors’ supervision of the domestic or international division investment policy. All conclusions should be documented.
4. Obtain the following:
  - a. Trial balances of investment-account holdings and money market instruments, such as commercial paper, banker’s acceptances, negotiable certificates of deposit, securities purchased under agreements to resell, and federal funds sold. Identify any depository instruments placed through money brokers.
  - b. A list of any assets carried in loans, and a list of discounts on which interest is exempt from federal income taxes and which are carried in the investment account on Call Reports.
  - c. A list of open purchase and sale commitments.
  - d. A schedule of all securities, forward placement contracts, futures contracts, contracts on exchange-traded puts and calls, option contracts on futures puts and calls, and standby contracts purchased or sold since the last examination.
  - e. A maturity schedule of securities sold under repurchase agreements.
  - f. A list of pledged assets and secured liabilities.
  - g. A list of the names and addresses of all securities dealers doing business with the bank.
  - h. A list of the bank’s personnel authorized to trade with dealers.
  - i. A list of all U.S. government–guaranteed loans that are recorded and carried as an investment-account security.
  - j. For international division and overseas branches, a list of investments—
    - held to comply with various foreign governmental regulations requiring such investments;
    - used to meet foreign reserve requirements;
    - required as stock exchange guarantees or used to enable the bank to provide securities services;
    - representing investment of surplus funds;
    - used to obtain telephone and telex services;
    - representing club and school memberships;
    - acquired through debts previously contracted;
    - representing minority interests in non-affiliated companies;
    - representing trading-account securities;
    - representing equity interests in Edge Act and agreement corporations and foreign banks;
    - representing portfolio investments made

- pursuant to Regulation K; and
    - held for other purposes.
- 5. Using updated data available from reports of condition, UBPR printouts, and investment adviser and correspondent bank portfolio-analysis reports, obtain or prepare an analysis of investment and money market holdings that includes—
  - a. a month-by-month schedule of par, book, and market values of issues maturing in one year;
  - b. schedules of par, book, and market values of holdings in the investment portfolio (schedules should be indexed by maturity date, and individual schedules should be detailed by maturity dates over the following time periods: over one through five years, over five through 10 years, and over 10 years);
  - c. book-value totals of holdings by obligor or industry; related obligors or industries; geographic distribution; yield; and special characteristics, such as moral obligations, conversion, or warrant features;
  - d. par-value schedules of type I, II, and III investment holdings, by those legally defined types; and
  - e. for the international division, a list of international investment holdings (foreign-currency amounts and U.S. dollar equivalents) to include—
    - descriptions of securities held (par, book, and market values),
    - names of issuers,
    - issuers' countries of domicile,
    - interest rates, and
    - pledged securities.
- 6. Review the reconciliation of investment and money market account (or accounts) trial balances to the general-ledger control account (or accounts).
- 7. Using either an appropriate sampling technique or the asset-coverage method, select from the trial balance (or balances) the international investments, municipal investments, and money market holdings for examination. If transaction volume permits, include all securities purchased since the last general examination in the population of items to be reviewed.
- 8. Perform the following procedures for each investment and money market holding selected in step 7:
  - a. Check appropriate legal opinions or pub-

lished data outlining legal status.

- b. If market prices are provided to the bank by an independent party (excluding affiliates and securities dealers selling investments to the bank) or if they are independently tested as a documented part of the bank's audit program, accept those prices. If the independence of the prices cannot be established, test market values by reference to one of the following sources:
  - published quotations, if available
  - appraisals by outside pricing services, if performed
- c. If market prices are provided by the bank and cannot be verified by reference to published quotations or other sources, test those prices by using the "comparative yield method" to calculate approximate yield to maturity:

approximate yield to maturity =

$$\frac{\text{annual interest} + \frac{\text{par value} - \text{book value}}{\text{number of years to maturity}}}{\frac{1}{2} (\text{bank-provided market price} + \text{par value})}$$

- Compare the bank-provided market price and the examiner-calculated approximate yield to maturity with an independent publicly offered yield or market price for a similar type of investment with similar rating, trading-volume, and maturity or call characteristics.
  - Compare nonrated issues with fourth-rated (BBB, Baa) bonds.
  - Investigate market-value variances in excess of 5 percent.
- d. For investments and money market obligations in the sample that are rated, compare the ratings provided with the most recent published ratings.

Before continuing, refer to steps 16 through 18. They should be performed in conjunction with steps 9 through 15. International division holdings should be reviewed with domestic holdings to ensure compliance, when combined, with applicable legal requirements.

9. To the extent practical under the circumstances, perform credit analyses of—
  - a. the obligors on securities purchased under agreements to resell, when the readily

- marketable value of the securities is not sufficient to satisfy the obligation;
- b. all international investments, nonrated securities, and money market instruments selected in step 7 or acquired since the last examination;
  - c. all previously detailed or currently known speculative issues;
  - d. all defaulted issues; and
  - e. any issues in the current Interagency Country Exposure Review Committee credit schedule obtained from the international loan portfolio manager by—
    - comparing the schedule with the foreign securities trial balance obtained in step 4 to ascertain which foreign securities are to be included in Interagency Country Exposure Review Committee credits;
    - for each security so identified, transcribing the following appropriate information to a separate examiner's line sheet or a related examiner's credit line sheet:
      - amount (and U.S. dollar equivalent if a foreign currency) to include par, book, and fair values
      - how and when acquired
      - maturity date (or dates)
      - default date, if appropriate
      - any pertinent comments; and
    - returning the schedule and the appropriate examiner's line sheet (or sheets) to the examiner who is assigned "International—Loan Portfolio Management."
10. Review the most recent reports of examination of the bank's Edge Act and agreement corporation affiliates and foreign subsidiaries to determine their overall conditions. Also, compile data on Edge Act and agreement corporations and foreign subsidiaries necessary for the commercial report of examination (that is, asset criticisms, transfer risk, and other material examination findings). Review portfolio investments made by Edge and agreement corporations under Regulation K for compliance with the investment limitations in Regulation K.
  11. Review the asset quality and the liquidity of all investment securities. Debt securities that have nontemporary impairments should be classified according to the June 15, 2004, interagency Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts. (See SR-04-9.) Classify speculative and defaulted issues according to the sub-investment-quality debt securities category of the agreement. No preferential treatment should be given to defaulted municipal securities. Comments to be included in the examination report are—
    - a. a description of the issue;
    - b. how and when each issue was acquired;
    - c. the default date, if appropriate;
    - d. the date up to which interest was paid;
    - e. the rating (or ratings)<sup>1</sup> at time of acquisition; and
    - f. other comments supporting the classification.
  12. Review the bank's investment-security maturity program.
    - a. Review the maturity schedules.
      - Compare the book values and the fair values and, after considering the gain or loss on year-to-date sales, determine if the costs of selling intermediate and long-term issues appear prohibitive.
      - Determine if recent acquisitions show a trend toward lengthened or shortened maturities. Discuss such trends with management, particularly with regard to investment objectives approved by the investment committee.
    - b. Review the pledged asset and secured liability schedules and isolate pledged securities by maturity segment. Then determine the fair value of securities pledged in excess of net secured liabilities.
    - c. Review the schedule of securities sold under repurchase agreement and determine—
      - whether financing for securities purchases is provided by repurchase agreement by the securities dealer who originally sold the security to the bank;
      - whether funds acquired through the sale of securities under agreement to repurchase are invested in money market assets, or if short-term repurchase agreements are being used to fund longer-term, fixed-rate assets;

1. The June 2004 interagency uniform agreement also addresses multiple ratings, the treatment of foreign debt securities, split or partially rated securities, and nonrated securities.

- the extent of matched asset repo and liability repo maturities and the overall effect on liquidity resulting from unmatched positions;
  - whether the interest rate paid on securities sold under agreement to repurchase is appropriate relative to current money market rates; and
  - whether the repurchase agreement is at the option of the buying or selling bank.
- d. Review the list of open purchase and sale commitments and determine the effect of their completion on maturity scheduling.
- e. Submit investment portfolio information regarding the credit quality and practical liquidity of the investment portfolio to the examiner who is assigned to review the “Asset/Liability Management.”
13. Consult with the examiner responsible for the asset/liability management analysis to determine what information is needed to assess the bank’s sensitivity to interest-rate fluctuations and its ability to meet short-term funding requirements. If requested, compile the information using bank records or other appropriate sources. See section 6000.1, “Instructions for the Report of Examination,” for factors to be taken into account when compiling this information. Information which may be required to be furnished includes—
- a. the fair value of unpledged government and federal-agency securities maturing within one year;
  - b. the fair value of other unpledged government and federal-agency securities which would be sold without loss;
  - c. the fair value of unpledged municipal securities maturing within one year;
  - d. the book value of money market instruments, such as banker’s acceptances, commercial paper, and certificates of deposit (provide amounts for each category); and
  - e. commitments to purchase and sell securities, including futures, forward, and standby contracts. (Provide a description of the security contract, the purchase or sales price, and the settlement or expiration date.)
14. Determine whether the bank’s investment policies and practices are satisfactorily balancing earnings and risk considerations.
- a. Use UBPR or average Call Report data to calculate investments as a percentage of total assets, and use average yields on U.S. government and nontaxable investments to—
    - compare results with peer-group statistics,
    - determine the reasons for significant variances from the norm, and
    - determine if trends are apparent and the reasons for such trends.
  - b. Calculate current market depreciation as a percentage of gross capital funds.
  - c. Review the analysis of municipal and corporate issues by rating classification and—
    - determine the total in each rating class and the total of nonrated issues,
    - determine the total of nonrated investment securities issued by obligors located outside of the bank’s service area (exclude U.S. government-guaranteed issues), and
    - review acquisitions since the prior examination and ascertain reasons for trends that may suggest a shift in the rated quality of investment holdings.
  - d. Review coupon rates or yields (when available) and compare those recently acquired investments and money market holdings with coupon rates or yields that appear high or low with similarly acquired instruments of analogous types, ratings, and maturity characteristics (Discuss significant rate or yield variances with management.)
  - e. Review the schedule of securities, futures, forward, and standby contracts purchased and sold since the last examination, and determine whether the volume of trading is consistent with policy objectives. (If the bank does not have a separate trading account, determine whether such an account should be established, including appropriate record-keeping and controls.)
  - f. If the majority of sales resulted in gains, determine if profit-taking is consistent with stated policy objectives or is motivated by anxiety for short-term income.
  - g. Determine whether the bank has discounted or has plans to discount future investment income by selling interest coupons in advance of interest-payment dates.

- h. Review the list of commitments to purchase or sell investments or money market investments. (Determine the effect

- of completion of these contracts on future earnings.).
15. Review the bank's federal income tax position and
    - a. determine, by discussion with appropriate officer(s), if the bank is taking advantage of procedures to minimize tax liability in view of other investment objectives;
    - b. review or compute actual and budgeted—
      - tax-exempt holdings as a percentage of total assets and
      - applicable income taxes as a percentage of net operating income before taxes; and
    - c. discuss with management the tax implications of losses resulting from securities sales.
  16. Determine that proper risk diversification exists within the portfolio by—
    - a. reviewing totals of holdings by single obligor or industry, related obligors or industries, geographic distribution, yields, and securities that have special characteristics (include individual due from bank accounts from the list received from the bank or from the examiner assigned "Due from Banks" and all money market instruments) and—
      - detail, as concentrations, all holdings equaling 25 percent or more of capital funds and
      - list all holdings equaling at least 10 percent but less than 25 percent of capital funds and submit that information to the examiner assigned "Loan Portfolio Management" (These holdings will be combined with any additional advances in the lending areas.) and
    - b. performing a credit analysis of all non-rated holdings determined to be a concentration if not performed in step 9.
  17. If the bank is engaged in financial futures, exchange-traded puts and calls, forward placement, or standby contracts, determine if—
    - a. the policy is specific enough to outline permissible contract strategies and their relationships to other banking activities;
    - b. recordkeeping systems are sufficiently detailed to permit a determination of whether operating personnel have acted in accordance with authorized objectives;
  - c. the board of directors or its designee has established specific contract position limits and reviews contract positions at least monthly to ascertain conformance with those limits;
  - d. gross and net positions are within authorized positions and limits, and if trades were executed by persons authorized to trade futures; and
  - e. the bank maintains general-ledger memorandum accounts or commitment registers which, at a minimum, include—
    - the type and amount of each contract,
    - the maturity date of each contract,
    - the current market price and cost of each contract, and
    - the amount held in margin accounts:
      - All futures contracts and forward and standby and options contracts are revalued on the basis of market or the lower of cost or market at each month-end.
      - Securities acquired as the result of completed contracts are valued at the lower of cost or market upon settlement.
      - Fee income received by the bank on standby contracts is accounted for properly.
      - Financial reports disclose futures, forwards, options, and standby activity.
      - The bank has instituted a system for monitoring credit-risk exposure in forward and standby contract activity.
      - The bank's internal controls, management reports, and audit procedures are adequate to ensure adherence to policy.
18. If the bank is engaged in financial futures, forward placement, options, or standby contracts, determine if the contracts have a reasonable correlation to the bank's business needs (including gap position) and capacity to fulfill its obligations under the contracts by—
  - a. comparing the contract commitment and maturity dates to anticipated offset,
  - b. reporting significant gaps to the examiner assigned "Asset/Liability Management" (refer to step 13),

- c. comparing the amounts of outstanding contracts to the amounts of the anticipated offset,
  - d. ascertaining the extent of the correlation between expected interest-rate movements on the contracts and the anticipated offset, and
  - e. determining the effect of the loss recognition on future earnings, and, if significant, reporting it to the examiner assigned “Analytical Review and Income and Expense.”
19. On the basis of pricings, ratings, and credit analyses performed above, and using the investments selected in step 7 or from lists previously obtained, test for compliance with applicable laws and regulations by—
- a. determining if the bank holds type II or III investments that are predominantly speculative in nature or securities that are not marketable (12 CFR 1.3(b));
  - b. reviewing the recap of investment securities by legal types, as defined by 12 CFR 1, on the basis of the legal restrictions of 12 USC 24 and competent legal opinions, as follows:
    - If a type II or III security is readily marketable, and if the purchaser’s judgment was based on evidence of the obligor’s ability to perform, determine if the par value of such securities issued by a single obligor, which the bank owns or is committed to purchase, exceeds 10 percent of the bank’s capital funds (12 CFR 1.5(a) and 1.7(a)).
    - If the holding of a type II or III security was based on a reliable estimate of the obligor’s ability to perform, determine if the aggregate par value of such issues exceeds 5 percent of the bank’s capital funds (12 CFR 1.5(b) and 1.7(b));
  - c. for those investment securities that are convertible into stock or which have stock purchase warrants attached—
    - determining if the book value has been written down to an amount that represents the investment value of the security, independent of the conversion or warrant provision (12 CFR 1.10) and
    - determining if the par values of other securities that have been ruled eligible for purchase are within specified capital limitations;
  - d. reviewing pledge agreements and secured liabilities and determining that—
    - proper custodial procedures have been followed,
    - eligible securities are pledged,
    - securities pledged are sufficient to secure the liability that requires securing,
    - Treasury Tax and Loan Remittance Option and Note Option are properly secured, and
    - private deposits are not being secured;

(Information needed to perform the above steps will be contained in the pledge agreement; Treasury circulars 92 and 176, as amended.)
  - e. reviewing accounting procedures to determine that—
    - investment premiums are being extinguished by maturity or call dates (12 CFR 1.11),
    - premium amortization is charged to operating income (12 CFR 1.11),
    - accretion of discount is included in current income for banks required to use accrual accounting for reporting purposes,
    - accretion of bond discount requires a concurrent accrual of deferred income tax payable, and
    - securities gains or losses are reported net of applicable taxes and net gains or losses are reflected in the period in which they are realized;
  - f. determining if securities purchased under agreement to resell are in fact securities (not loans), are eligible for investment by the bank, and are within prescribed limits (12 USC 24 and 12 CFR 1). If not, determine whether the transaction is within applicable state legal lending limits;
  - g. reviewing securities sold under agreement to repurchase and determining whether they are, in fact, deposits (Regulation D, 12 CFR 204.2(a)(1));
  - h. determining that securities and money market investments held by foreign branches comply with section 211.3 of Regulation K—Foreign Branches of Member Banks (12 CFR 211.3) as to—
    - acquiring and holding securities (section 211.3(b)(3)) and



- underwriting, distributing, buying, and selling obligations of the national government of the country in which the branch is located (section 211.3(b)(4)); and

(Further considerations relating to the above are contained in other sections of Regulation K. Also review any applicable sections of Regulation T—Credit by Brokers and Dealers (12 CFR 220), Regulation X—Borrowers of Securities Credit (12 CFR 224), and Board Interpretations 6150 (regarding securities issued or guaranteed by the International Bank for Reconstruction and Development) and 6200 (regarding borrowing by a domestic broker from a foreign broker). Edge Act and agreement corporations are discussed in the Bank-Related Organizations section.

- i. determining that the bank's equity investments in foreign banks comply with the provisions of section 25 of the Federal Reserve Act and section 211.5 of Regulation K as to—
  - investment limitations (section 211.5(b)) and
  - investment procedures (section 211.5(c)).
20. Test for compliance with other laws and regulations as follows:
  - a. Review lists of affiliate relationships and lists of directors and principal officers and their interests.
    - Determine if the bank is an affiliate of a firm that primarily is engaged in underwriting or selling securities (12 USC 377).
    - Determine if directors or officers are engaged in or employed by firms that are engaged in similar activities (12 USC 78, 377, and 378). (It is an acceptable practice for bank officers to act as directors of securities companies not doing business in the United States, the stock of which is owned by the bank as authorized by the Board of Governors of the Federal Reserve System.)
    - Review the list of federal funds sold, securities purchased under agreements to resell, interest-bearing time deposits, and commercial paper, and determine if the bank is investing in money market instruments of affiliated banks or firms (section 23A, Federal Reserve Act, and 12 USC 371(c)).
  - b. Determine if transactions involving affiliates, insiders, or their interests have terms that are less favorable to the bank than transactions involving unrelated parties (sections 23A and 22, Federal Reserve Act, and 12 USC 371c, 375, 375a, and 375b).
  - b. Determine if Federal Reserve stock equals 3 percent of the subject bank's booked capital and surplus accounts (Regulation I, 12 CFR 209).
  - c. Review the nature and duration of federal-funds sales to determine if term federal funds are being sold in an amount exceeding the limit imposed by state legal lending limits.
21. With regard to potential unsafe and unsound investment practices and possible violations of the Securities Exchange Act of 1934, review the list of securities purchased and/or sold since the last examination and—
  - a. determine if the bank engages one securities dealer or salesperson for virtually all transactions. If so—
    - evaluate the reasonableness of the relationship on the basis of the dealer's location and reputation and
    - compare purchase and sale prices to independently established market prices as of trade dates, if appropriate;
  - b. determine if investment-account securities have been purchased from the bank's own trading department. If so—
    - independently establish the market price as of trade date,
    - review trading-account purchase and sale confirmations and determine if the security was transferred to the investment portfolio at market price, and
    - review controls designed to prevent dumping; and
  - c. determine if the volume of trading activity in the investment portfolio appears unwarranted. If so—
    - review investment-account daily ledgers and transaction invoices to determine if sales were matched by a like amount of purchases,
    - determine whether the bank is financing a dealer's inventory,
    - compare purchase and sale prices with independently established market prices

- as of trade dates, if appropriate. The carrying value should be determined by the market value of the securities as of the trade date, and
- cross-reference descriptive details on investment ledgers and purchase confirmations to the actual bonds or safekeeping receipts to determine if the bonds delivered are those purchased.
22. Discuss with appropriate officer(s) and prepare report comments on—
- a. defaulted issues;
  - b. speculative issues;
  - c. incomplete credit information;
  - d. absence of legal opinions;
  - e. significant changes in maturity scheduling;
  - f. shifts in the rated quality of holdings;
  - g. concentrations;
  - h. unbalanced earnings and risk considerations;
  - i. unsafe and unsound investment practices;
  - j. apparent violations of laws, rulings, and regulations and the potential personal liability of the directorate;
  - k. significant variances from peer-group statistics;
  - l. market-value depreciation, if significant;
  - m. weaknesses in supervision;
  - n. policy deficiencies; and
  - o. material problems being encountered by the bank's Edge Act and agreement corporation affiliates, and other related international concerns, that could affect the condition of the bank.
23. The following guidelines are to be implemented while reviewing securities participations, purchases/sales, swaps, or other transfers. The guidelines are designed to ensure that securities transfers involving state member banks, bank holding companies, and nonbank affiliates are carefully evaluated to determine if they were carried out to avoid classification and to determine the effect of the transfer on the condition of the institution. In addition, the guidelines are designed to ensure that the primary regulator of the other financial institution involved in the transfer is notified.
- a. Investigate any situations in which securities were transferred before the date of examination to determine if any were transferred to avoid possible criticism during the examination.
  - b. Determine whether any of the securities transferred were nonperforming at the time of transfer, classified at the previous examination, depreciated or sub-investment-grade, or for any other reason were considered to be of questionable quality.
  - c. Review the bank's policies and procedures to determine whether or not securities purchased by the bank are given an independent, complete, and adequate credit evaluation. If the bank is a holding company subsidiary or a member of a chain banking organization, review securities purchases or participations from affiliates or other known members of the chain to determine if the securities purchases are given an *arm's-length* and *independent* credit evaluation by the purchasing bank.
  - d. Determine whether or not any bank purchases of securities from an affiliate are in conformance with section 23A, which generally prohibits purchases of low-quality assets from an affiliate.
  - e. Determine that any securities purchased by the bank are properly reflected on its books at fair market value (fair market value should at a minimum reflect both the rate of return being earned on such assets and an appropriate risk premium). Determine that appropriate write-offs are taken on any securities sold by the bank at less than book value.
  - f. Determine that transactions involving transfers of low-quality securities to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and the holding company affiliate.
  - g. If poor-quality securities were transferred to or from another financial institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
    - name of originating and receiving institutions
    - type of securities involved and type of transfer (i.e., participation, purchase/sale, swap)

- date(s) of transfer
  - total number and dollar amount of securities transferred
  - status of the securities when transferred (e.g., rating, depreciation, non-performing, classified, etc.)
  - any other information that would be helpful to the other regulator.
24. Reach a conclusion regarding the quality of department management. Communicate your conclusion to the examiner assigned “Management Assessment” and the examiner who is in charge of the international examination, if applicable.
25. Update workpapers with any information that will facilitate future examination. If the bank has overseas branches, indicate those securities requiring review during the next overseas examination and the reasons for the review.

# Investment Securities and End-User Activities

## Internal Control Questionnaire

Effective date November 1995

## Section 2020.4

Review the bank's internal controls, policies, practices, and procedures regarding purchases, sales, and servicing of the investment portfolio. The bank's system should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written investment securities policies, including WI securities, futures, and forward placement contracts, that outline—
  - a. objectives,
  - b. permissible types of investments,
  - c. diversification guidelines to prevent undue concentration,
  - d. maturity schedules,
  - e. limitation on quality ratings,
  - f. policies regarding exceptions to standard policy, and
  - g. valuation procedures and frequency?
2. Are investment policies reviewed at least annually by the board to determine if they are compatible with changing market conditions?
3. Are securities designated at time of purchase as to whether they are investments for the portfolio or trading account?
4. Have policies been established governing the transfer of securities from the trading account to the investment-securities account?
5. Have limitations been imposed on the investment authority of officers?
- \*6. Do security transactions require dual authorization?
7. If the bank has due from commercial banks or other depository institutions time, federal funds sold, commercial paper, securities purchased under agreements to resell, or any other money market type of investment—
  - a. is purchase or sale authority clearly defined,
  - b. are purchases or sales reported to the

- board of directors or its investment committee,
- c. are maximums established for the amount of each type of asset,
  - d. are maximums established for the amount of each type of asset that may be purchased from or sold to any one bank,
  - e. do money market investment policies outline acceptable maturities, and
  - f. have credit standards and review procedures been established?

### CUSTODY OF SECURITIES

- \*8. Do procedures preclude the custodian of the bank securities from—
  - a. having sole physical access to securities;
  - b. preparing release documents without the approval of authorized persons;
  - c. preparing release documents not subsequently examined or tested by a second custodian; and
  - d. performing more than one of the following transactions: (1) execution of trades, (2) receipt or delivery of securities, (3) receipt and disbursement of proceeds?
- \*9. Are securities physically safeguarded to prevent loss or unauthorized removal or use?
10. Are securities, other than bearer securities, held only in the name or nominee of the bank?
11. When a negotiable certificate of deposit is acquired, is the certificate safeguarded in the same manner as any other negotiable investment instrument?

### RECORDS

12. Do subsidiary records of investment securities show all pertinent data describing the security; its location; pledged or unpledged status; premium amortization; discount accretion; and interest earned, collected, and accrued?

- \*13. Is the preparation and posting of subsidiary records performed or reviewed by persons who do not also have sole custody of securities?
- \*14. Are subsidiary records reconciled at least monthly to the appropriate general-ledger accounts, and are reconciling items investigated by persons who do not also have sole custody of securities?
15. For international-division investments, are entries for U.S. dollar carrying values of foreign currency-denominated securities rechecked at inception by a second person?
- b. notified in writing of revocation of trading authority?
22. Has the bank established futures and forward trading limits—
- for individual traders,
  - for total outstanding contracts,
  - which are endorsed by the board or an appropriate board committee, and
  - the basis of which is fully explained?
23. Does the bank obtain prior written approval detailing amount of, duration, and reason—
- for deviations from individual limits and
  - for deviations from gross trading limits?
24. Are these exceptions subsequently submitted to the board or an appropriate board committee for ratification?
25. Does the trader prepare a prenumbered trade ticket?
26. Does the trade ticket contain all of the following information:
- trade date
  - purchase or sale
  - contract description
  - quantity
  - price
  - reason for trade
  - reference to the position being matched (immediate or future case settlement)
  - signature of trader
27. Are the accounting records maintained and controlled by persons who cannot initiate trades?
28. Are accounting procedures documented in a procedures manual?
29. Are all incoming trade confirmations—
- received by someone independent of the trading and recordkeeping functions and
  - verified to the trade tickets by this independent party?
30. Does the bank maintain general-ledger control accounts disclosing, at a minimum—
- futures or forward contracts memorandum accounts,
  - deferred gains or losses, and
  - margin deposits?
31. Are futures and forward contracts activities—
- supported by detailed subsidiary records and
  - agreed daily to general-ledger controls by someone who is not authorized to prepare general-ledger entries?

## PURCHASES, SALES, AND REDEMPTIONS

- \*16. Is the preparation and posting of security and open contractual commitments purchase, sale, and redemption records performed or reviewed by persons who do not also have sole custody of securities or authorization to execute trades?
- \*17. Are supporting documents, such as brokers' confirmations and account statements for recorded purchases and sales checked or reviewed subsequently by persons who do not also have sole custody of securities or authorization to execute trades?
- \*18. Are purchase confirmations compared to delivered securities or safekeeping receipts to determine if the securities delivered are the securities purchased?

## FUTURES CONTRACTS, FORWARD PLACEMENT CONTROLS

19. Do futures and forward contract policies—
- outline specific strategies and
  - relate permissible strategies to other banking activities?
20. Are the formalized procedures used by the trader—
- documented in a manual and
  - approved by the board or an appropriate board committee?
21. Are the bank's futures commission merchant(s) and/or forward brokers—
- notified in writing to trade with only those persons authorized as traders and

32. Do periodic statements received from futures commission merchants reflect—
  - a. trading activity for the period,
  - b. open positions at the end of the period,
  - c. market value of open positions,
  - d. unrealized gains and losses, and
  - e. cash balances in accounts?
33. Are all of these periodic statements—
  - a. received by someone independent of both the trading and recordkeeping functions and
  - b. reconciled to all of the bank's accounting records?
34. Are the market prices reflected on the statements—
  - a. verified with listed prices from a published source and
  - b. used to recompute gains and losses?
35. Are daily reports of unusual increases in trading activity reviewed by senior management?
36. Are weekly reports prepared for an appropriate board committee which reflect—
  - a. all trading activity for the week,
  - b. open positions at the end of the week,
  - c. market value of open positions,
  - d. unrealized gains and losses,
  - e. total trading limits outstanding for the bank, and
  - f. total trading limits for each authorized trader?
37. Is the futures and forward contracts portfolio revalued monthly to market value or to the lower of cost or market?
38. Are revaluation prices provided by persons or sources totally independent of the trading function?

## OTHER

39. Does the board of directors receive regular reports on domestic and international-division investment securities which include—
  - a. valuations,
  - b. maturity distributions,
  - c. average yield, and
  - d. reasons for holding and benefits received (international-division and overseas holdings only)?
40. Are purchases, exchanges, and sales of securities and open contractual commitments ratified by action of the board of directors or its investment committee and thereby made a matter of record in the minutes?

## CONCLUSION

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

This section sets forth the June 29, 2011, “Inter-agency Supervisory Guidance of Counterparty Credit Risk Management” issued by the federal banking agencies.<sup>1</sup> The guidance discusses the critical aspects of effective management of counterparty credit risk (CCR), and it sets forth sound practices and supervisory expectations for the development of an effective CCR-management framework. CCR is the risk that the counterparty to a transaction could default or deteriorate in creditworthiness before the final settlement of a transaction’s cash flows. Unlike the credit risk for a loan, when only the lending banking organization faces the risk of loss, CCR creates a bilateral risk of loss because the market value of a transaction can be positive or negative to either counterparty. The future market value of the exposure and the counterparty’s credit quality are uncertain and may vary over time as underlying market factors change.

This CCR guidance is intended for use by banking organizations,<sup>2</sup> especially those with large derivatives portfolios, in setting their risk-management practices as well as by supervisors as they assess and examine such institutions’ management of CCR. For other banking organizations without large derivatives portfolios, risk managers and supervisors should apply this guidance as appropriate, given the size, nature, and complexity of the CCR risk profile of the banking organization, although this guidance would generally not apply to community banking organizations.

CCR is a multidimensional form of risk, affected by both the exposure to a counterparty and the credit quality of the counterparty, both of which are sensitive to market-induced changes. It is also affected by the interaction of these risks—for example, the correlation<sup>3</sup> between an

exposure and the credit spread of the counterparty, or the correlation of exposures among the banking organization’s counterparties. Constructing an effective CCR-management framework requires a combination of risk-management techniques from the credit-, market-, and operational-risk disciplines.

This guidance reinforces sound governance of CCR-management practices, through prudent board and senior management oversight, management reporting, and risk-management functions. The guidance also elaborates on the sound practices for an effective CCR-management framework and associated characteristics of adequate systems infrastructure. It also covers risk-control functions, such as counterparty limits, margin practices, validating and backtesting models and systems, managing close-outs,<sup>4</sup> managing central counterparty exposures, and controlling legal and operational risks arising from derivatives activities.

CCR-management guidelines and supervisory expectations are delineated in various individual and interagency policy statements and guidance,<sup>5</sup> which remain relevant and applicable. This guidance offers further explanation and clarification, particularly in light of developments in CCR management. However, this guidance is not all-inclusive, and banking organizations should reference sound practices for CCR management, such as those advanced by industry, policymaking, and supervisory forums.<sup>6</sup> (See SR 11-10.)

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4. A close-out is the process undertaken by a banking organization following default of a counterparty to fully collect on all items due from that counterparty.

5. See, for example, the FFIEC “Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities,” 63 *Fed. Reg.* 20191, April 23, 1998. Federal Reserve examination guidance on CCR is contained in SR-99-3, section 2126.3 of the *Bank Holding Company Supervision Manual* and section 2020.1 of the *Trading and Capital-Markets Activities Manual*.

6. Industry, policymaking, and supervisory groups include, but are not limited to, the Counterparty Risk Management Policy Group (CRMPG), Committee on Payment and Settlement Systems (CPSS), International Swaps and Derivatives Association (ISDA), Institute of International Finance (IIF), Group of Thirty (G30), Group of Twenty Finance Ministers and Central Bank Governors (G-20), International Organization of Securities Commissions (IOSCO), Senior Supervisors Group (SSG), and Basel Committee on Banking Supervision (BCBS). Documents produced by all of these groups were drawn upon in developing this guidance.

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1. The Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC). The former Office of Thrift Supervision (OTS) also participated in developing this guidance.

2. For the purposes of this CCR guidance, unless otherwise indicated, the term *banking organizations* is intended to refer to state member banks, state nonmember banks, national banks, federal savings associations, state-chartered savings associations, bank holding companies, and savings and loan holding companies. The U.S. branches and agencies of foreign banks are also considered to be banking organizations for purposes of this guidance.

3. In this guidance, “correlation” refers to any form of linear or nonlinear interrelationship or dependence between factors.



## GOVERNANCE

### Board and Senior Management Responsibilities

The board of directors or a designated board-level committee (board) should clearly articulate the banking organization's risk tolerance for CCR by approving relevant policies, including a framework for establishing limits on individual counterparty exposures and concentrations of exposures. Senior management should establish and implement a comprehensive risk-measurement and management framework consistent with this risk tolerance that provides for the ongoing monitoring, reporting, and control of CCR exposures.

Senior management should adhere to the board's established risk tolerance and should establish policies and risk-management guidelines appropriately. At a minimum, policies should outline CCR-management standards that are in conformance with this guidance. More specifically, they should address the subjects discussed in this document, such as risk measurement and reporting, risk-management tools, and processes to manage legal and operational risk. Policies should be detailed and contain a clear escalation process for review and approval of policy exceptions, especially those pertaining to transaction terms and limits.

### Management Reporting

Banking organizations should report counterparty exposures to the board and senior management at a frequency commensurate with the materiality of exposures and the complexity of transactions. Reporting should include concentration analysis and CCR stress-testing results to allow for an understanding of exposures and potential losses under severe market conditions. Reports should also include an explanation of any measurement weaknesses or limitations that may influence the accuracy and reliability of the CCR risk measures.

Senior management should have access to timely, accurate, and comprehensive CCR reporting metrics, including an assessment of significant issues related to the risk-management aspects discussed in this guidance. They should review CCR reports at least monthly, with data that are no more than three weeks old. It is

general practice for institutions to report the following:

- total counterparty credit risk aggregated on a firm-wide basis and at significant legal entities
- counterparties with the largest exposures, along with detail on their exposure amounts
- exposures to central counterparties (CCPs)
- significant concentrations, as outlined in this guidance
- exposures to weak or problem counterparties
- growth in exposures over time; as a sound practice, metrics should capture quarterly or monthly changes, supplemented (where relevant) by year-over-year trend data
- exposures from over-the-counter (OTC) derivatives; when they are material, additional product-class breakouts (for example, traditional lending, securities lending) should be included
- a sufficiently comprehensive range of CCR metrics, as discussed in the CCR metrics section
- a qualitative discussion of key risk drivers of exposures or conditions or factors that would fundamentally change the risk profile of CCR; an example would be assessment of changes in credit underwriting terms and whether they remain prudent

### Risk-Management Function and Internal Audit

#### *Risk Management*

A banking organization's board and senior management should clearly delineate the respective roles of business lines versus risk management, both in terms of initiating transactions that have CCR and of ongoing CCR management. The board and senior management should ensure that the risk-management functions have adequate resources, are fully independent from CCR-related trading operations (in both activity and reporting), and have sufficient authority to enforce policies and to escalate issues to senior management and the board (independent of the business line).

#### *Internal Audit*

The board should direct internal audit to regularly assess the adequacy of the CCR-



management framework as part of the regular audit plan. Such assessments should include credit-line approval processes, credit ratings, and credit monitoring. Such an assessment should opine on the adequacy of the CCR infrastructure and processes, drawing where appropriate from individual business line reviews or other internal and external audit work. (See the relevant section of this guidance regarding the role of CCR model validation or review.) The board should review annual reports from internal audit and model validation or review, assessing the findings and confirming that management has taken appropriate corrective actions.

## RISK MEASUREMENT

### CCR Metrics

Given the complexity of CCR exposures (particularly regarding OTC derivatives), banking organizations should employ a range of risk-measurement metrics to promote a comprehensive understanding of CCR and how it changes in varying environments. Metrics should be commensurate with the size, complexity, liquidity, and risk profile of the CCR portfolio. Banking organizations typically rely on certain metrics as a primary means of monitoring, with secondary metrics used to create a more robust view of CCR exposures. Banking organizations should apply these metrics to single counterparty exposures, groups of counterparties (for example, by internal rating, industry, geographical region), and the consolidated CCR portfolio. Banking organizations should assess their largest exposures, for instance their top 20 exposures, using each primary metric.

Major dealers and large, sophisticated banking organizations with substantial CCR exposure should measure and assess

- current exposure (both gross and net of collateral);
- forward-looking exposure (that is, potential exposure);
- stressed exposure (broken out by market-risk factors and/or by scenario);
- aggregate and stressed credit valuation adjustment (CVA) as well as CVA factor sensitivities;
- additional relevant risk measures, such as (for credit derivatives) jump-to-default risk on the reference obligor, and economic capital usage;

- the largest exposures by individual business line and product types; and
- correlation risks, such as wrong-way risk, as well as the credit quality of collateral.

Refer to this section's Appendix A for definitions of basic metrics and descriptions of their purposes.

### Aggregation of Exposures

Banking organizations should have the capacity to measure their exposure at various levels of aggregation (for example, by business line, legal entity, or consolidated by industry). Systems should be sufficiently flexible to allow for timely aggregation of all CCR exposures (that is, OTC derivatives, securities financing transactions (SFTs), and other presettlement exposures), as well as aggregation of other forms of credit risk to the same counterparty (for example, loans, bonds, and other credit risks). The following are sound CCR-aggregation principles:

- Counterparty-level current exposure and potential exposure should be calculated daily, based on the previous day's position data and any exchange of collateral.
- For each organizational level of aggregation, all trades should be included.
- There should be sufficient flexibility to aggregate exposure at varying levels of granularity, including industries, regions, families of products (for example, OTC derivatives, SFTs), or other groupings to identify concentrations.
- While banking organizations are not required to express all forms of risk in a common metric or basis, management should be able to view the various forms of exposures to a given counterparty in a single report and/or system. Specifically, this could include current outstanding exposure across different categories (e.g., current exposure for OTC derivatives and drawn-down lines of commitment for loans). Exposure reports should also include the size of settlement and clearing lines.
- Banking organizations should be consistent in their choice of currency and exchange rate, and take into account the validity and legal enforceability of any netting agreements they may have with a counterparty.
- Management should understand the specific approach used to aggregate exposures for any

given risk measure, in order to properly assess the results. For instance, some measures of risk (such as current exposure) may be readily added together, while others (such as potential exposure) are less meaningful when they are added to form an aggregate view of risk.

- Internal capital adequacy models should incorporate CCR.

## Concentrations

Concentrated exposures are a significant concern, as CCR can contribute to sudden increases in credit exposure, which in turn can result in unexpectedly large losses in the event of counterparty default. Accordingly, banking organizations should have enterprise-wide processes to effectively identify, measure, monitor, and control concentrated exposures on both a legal entity and enterprise-wide basis.

Concentrations should be identified using both quantitative and qualitative means. An exposure or group of related exposures (for example, firms in the same industry), should be considered a concentration in the following circumstances: exposures (individually or collectively) exceed risk-tolerance levels established to ensure appropriate diversification; deterioration of the exposure could result in material loss; or deterioration could result in circumstances that are detrimental to the banking organization's reputation. All credit exposures should be considered as part of concentration management, including loans, OTC derivatives, names in bespoke and index CDO credit tranches, securities settlements, and money market transactions such as fed funds sold. Total credit exposures should include the size of settlement and clearing lines or other committed lines.

CCR-concentration management should identify, quantify, and monitor the following:

- Individual counterparties with large potential exposures, when those exposures are driven by a single market factor or transaction type. In these circumstances, banking organizations should supplement statistical measures of potential exposure with other measures, such as stress tests, that identify such concentrations and provide an alternative view of risks associated with close-outs.
- Concentrations of exposures to individual legal entities, as well as concentrations across affili-

ated legal entities at the parent entity level, or in the aggregate for all related entities.

- Concentrations of exposures to industries or other obligor groupings.
- Concentrations of exposures to geographic regions or country-specific groupings sensitive to similar macroeconomic shocks.
- Concentrations across counterparties when potential exposure is driven by the same or similar risk factors. For both derivatives and SFTs, banking organizations should understand the risks associated with crowded trades,<sup>7</sup> where close-out risk may be heightened under stressed market conditions.
- Collateral concentrations, including both risk concentrations with a single counterparty and risks associated with portfolios of counterparties. Banking organizations should consider concentrations of noncash collateral for all product lines covered by collateral agreements,<sup>8</sup> including collateral that covers a single counterparty exposure and portfolios of counterparties.<sup>9</sup>
- Collateral concentrations involving special purpose entities (SPEs). Collateral-concentration risk is particularly important for SPEs, because the collateral typically represents an SPE's paying capacity.
- Banking organizations should consider the full range of credit risks in combination with CCR to manage concentration risk, including risks from on- and off-balance-sheet activities, contractual and noncontractual risks, contingent and noncontingent risks, as well as underwriting and pipeline risks.

## Stress Testing

Banking organizations with significant CCR exposures should maintain a comprehensive stress-testing framework, which is integrated

7. For purposes of this guidance, a "crowded trade" is a large balance of open trading positions in a given asset or group of assets relative to its daily trading volume, when other market participants have similar positions that would need to be liquidated should any adverse price change occur. Coincident sale of these assets by a large number of market participants could lead to significant price declines and dramatic increases in uncollateralized exposures.

8. Banking organizations should also track concentrations in volatile currencies.

9. This analysis is particularly important with repo-style transactions and other forms of SFTs for which the ability of market participants to liquidate large collateral positions may be difficult during periods of market turbulence.

into the banking organization's CCR management. The framework should inform the banking organization's day-to-day exposure and concentration management, and it should identify extreme market conditions that could excessively strain the financial resources of the banking organization. Regularly, but no less than quarterly, senior management should evaluate stress-test results for evidence of potentially excessive risk and take risk-reduction strategies as appropriate.

The severity of factor shocks should be consistent with the purpose of the stress test. When evaluating solvency under stress, factor shocks should be severe enough to capture historical extreme market environments and/or extreme-but-plausible stressed market conditions. The impact of such shocks on capital resources and earnings should be evaluated. For day-to-day portfolio monitoring, hedging, and management of concentrations, banking organizations should also consider scenarios of lesser severity and higher probability. When conducting stress testing, risk managers should challenge the strength of assumptions made about the legal enforceability of netting and the ability to collect and liquidate collateral.

A sound stress-testing framework should include the following:

- Measurement of the largest counterparty-level impacts across portfolios, material concentrations within segments of a portfolio (such as industries or regions), and relevant portfolio- and counterparty-specific trends.
- Complete trade capture and exposure aggregation across all forms of trading (not just OTC derivatives) at the counterparty-specific level, including transactions that fall outside of the main credit system. The time frame selected for trade capture should be commensurate with the frequency with which stress tests are conducted.
- Stress tests, at least quarterly, of principal market-risk factors on an individual basis (for example, interest rates, foreign exchange, equities, credit spreads, and commodity prices) for all material counterparties. Banking organizations should be aware that some counterparties may be material on a consolidated basis, even though they may not be material on an individual legal-entity basis.
- Assessment of nondirectional risks (for example, yield-curve exposures and basis risks) from multifactor stress-testing scenarios. Mul-

tifactor stress tests should, at a minimum, aim to address separate scenarios: severe economic or market events; significant decrease in broad market liquidity; and the liquidation of a large financial intermediary of the banking organization, factoring in direct and indirect consequences.

- Consideration, at least quarterly, of stressed exposures resulting from the joint movement of exposures and related counterparty credit-worthiness. This should be done at the counterparty-specific and counterparty-group (for example, industry and region) level, and in aggregate for the banking organization. When CVA methodologies are used, banking organizations should ensure that stress testing sufficiently captures additional losses from potential defaults.<sup>10</sup>
- Basic stress testing of CVA to assess performance under adverse scenarios, incorporating any hedging mismatches.
- Concurrent stress testing of exposure and noncash collateral for assessing wrong-way risk.
- Identification and assessment of exposure levels for certain counterparties (for example, sovereigns and municipalities), above which the banking organization may be concerned about willingness to pay.
- Integration of CCR stress tests into firm-wide stress tests.<sup>11</sup>

## Credit Valuation Adjustments

CVA refers to adjustments to transaction valuation to reflect the counterparty's credit quality. CVA is the fair-value adjustment to reflect CCR in valuation of derivatives. As such, CVA is the market value of CCR and provides a market-based framework for understanding and valuing the counterparty credit risk embedded in derivative contracts. CVA may include only the adjustment to reflect the counterparty's credit quality (a one-sided CVA or just CVA), or it may include an adjustment to reflect the banking organization's own credit quality. The latter is a two-sided CVA, or CVA plus a debt valuation

10. Exposure testing should include single-factor, multifactor, and material nondirectional risks.

11. CCR stress testing should be consistent with overall banking-organization-wide stress testing and follow the principles set forth in the "Principles for Sound Stress Testing Practices and Supervision" issued by the Risk Management and Modeling Group of the Basel Committee in May 2009.

adjustment (DVA). For the evaluation of the credit risk due to probability of default of counterparties, a one-sided CVA is typically used. For the evaluation of the value of derivatives transactions with a counterparty or the market risk of derivatives transactions, a two-sided CVA should be used.

Although CVA is not a new concept, its importance has grown, partly because of a change in accounting rules that requires banking organizations to recognize the earnings impact of changes in CVA.<sup>12</sup> During the 2007–2009 financial crisis, a large portion of CCR losses were because of CVA losses rather than actual counterparty defaults.<sup>13</sup> As such, CVA has become more important in risk management, as a mechanism to value, manage, and make appropriate hedging decisions, to mitigate banking organizations' exposure to the mark-to-market (MTM) impact of CCR.<sup>14</sup> The following are general standards for CVA measurement and use of CVA for risk-management purposes:

- CVA calculations should include all products and counterparties, including margined counterparties.
- The method for incorporating counterparty credit quality into CVA should be reasonable and subject to ongoing evaluation. CVA should reflect the fair value of the counterparty credit risk for OTC derivatives, and inputs should be based on current market prices when possible.
  - Credit spreads should be reflected in the calculation where available, and banking organizations should not overly rely on non-market-based probability of default estimates when calculating CVA.
  - Banking organizations should attempt to map credit quality to name-specific spreads rather than spreads associated with broad credit categories.
  - Any proxy spreads should reasonably cap-

12. See the Financial Accounting Standards Board's accounting literature pertinent to CVA in Accounting Standards Codification (ASC) Topic 820 (formerly FAS Statement 157). In addition, other transaction fair-value adjustments should be conducted—for example, those involving a banking organization's own credit risk or differences in funding costs based on whether transactions are collateralized or not.

13. Basel Committee on Banking Supervision, "Strengthening the Resilience of the Banking Sector—Consultative Document," December 2009.

14. An accurate measure of CVA is critical to prudent risk-taking, as part of effectively understanding the risk-reward tradeoff in a given derivatives transaction. The more comprehensively CVA is measured, the more transparent the economics of a given transaction.

ture the idiosyncratic nature of the counterparty and the liquidity profile.

- The term structure of credit spreads should be reflected in the CVA calculation.
- The CVA calculation should incorporate counterparty-specific master netting agreements and margin terms; for example, the CVA calculation should reflect margin thresholds or minimum transfer amounts stated in legal documents.
- Banking organizations should identify the correlation between a counterparty's creditworthiness and its exposure to the counterparty, and seek to incorporate the correlation into their respective CVA calculation.

### *Management of CVA*

CVA management should be consistent with sound risk-management practices for other material MTM risks. These practices should include the following:

- Business units engaged in trades related to CVA management should have independent risk-management functions overseeing their activities.
- Systems that produce CVA risk metrics should be subject to the same controls as used for other MTM risks, including independent validation or review of all risk models, including alternative methodologies.<sup>15</sup>
- Upon transaction execution, CVA costs should be allocated to the business unit that originates the transaction.
  - As a sound practice, the risk of CVA should be incorporated into the risk-adjusted return calculation of a given business.
  - CVA cost allocation provides incentive for certain parties to make prudent risk-taking decisions and motivates risk-takers to support risk mitigation, such as requiring strong collateral terms.
- Banking organizations should measure sensitivities to changes in credit- and market-risk factors to determine the material drivers of MTM changes. On a regular basis, but no less

15. Liquidity in credit markets has varied significantly over time. As liquidity conditions change, banking organizations should calculate CVA using methodologies appropriate to the market pricing information available for each counterparty and transaction type.

frequently than quarterly, banking organizations should ensure that CVA MTM changes are sufficiently explained by these risk factors (for example, through profit and loss attribution for sensitivities and backtesting for value at risk (VaR)).

- Banking organizations hedging CVA MTM should gauge the effectiveness of hedges through measurements of basis risk or other types of mismatches. In this regard, it is particularly important to capture nonlinearities, such as the correlation between market and credit risk, and other residual risks that may not be fully offset by hedging.

### CVA VaR

Banking organizations with material CVA should measure the risk of associated loss on an ongoing basis. In addition to stress tests of the CVA, banking organizations may develop VaR models that include CVA to measure potential losses. While these models are currently in the early stages of development, they may prove to be effective tools for risk-management purposes. An advantage of CVA VaR over more traditional CCR risk measures is that it captures the variability of the CCR exposure, the variability of the counterparty's credit spread, and the dependency between them.

Developing VaR models for CVA is significantly more complicated than developing VaR models for a banking organization's market-risk positions. In developing a CVA VaR model, a banking organization should match the percentile and time horizon for the VaR model to those appropriate for the management of this risk, and include all significant risks associated with changes in the CVA. For example, banking organizations may use the same percentile for CVA VaR as they use for market-risk VaR (for example, the 95th or 99th percentile). However, the time horizon for CVA VaR may need to be longer than for market risk (for example, one quarter or one year) because of the potentially illiquid nature of CVA. The following are important considerations in developing a CVA VaR model:

- All material counterparties covered by CVA valuation should be included in the VaR model.
- A CVA VaR calculation that keeps the exposure or the counterparty probability of default

static is not adequate. It will not only omit the dependence between the two variables, but also the risk arising from the uncertainty of the fixed variable.

- CVA VaR should incorporate all forms of CVA hedging. Banking organizations and examiners should assess the ability of the VaR measure to accurately capture the types of hedging used by the banking organization.

### Wrong-Way Risk

Wrong-way risk occurs when the exposure to a particular counterparty is positively correlated with the probability of default of the counterparty itself. Specific wrong-way risk arises when the exposure to a particular counterparty is positively correlated with the probability of default of the counterparty itself because of the nature of the transactions with the counterparty. General wrong-way risk arises when the probability of default of counterparties is positively correlated with general market-risk factors. Wrong-way risk is an important aspect of CCR that has caused major losses at banking organizations. Accordingly, a banking organization should have a process to systematically identify, quantify, and control both specific and general wrong-way risk across its OTC derivative and SFT portfolios.<sup>16</sup> To prudently manage wrong-way risk, banking organizations should

- maintain policies that formally articulate tolerance limits for both specific and general wrong-way risk, an ongoing wrong-way risk identification process, and the requirements for escalation of wrong-way risk analysis to senior management;
- maintain policies for identifying, approving, and otherwise managing situations when there is a legal connection between the counterparty and the underlying exposure or the associated collateral<sup>17</sup> (banking organizations should gen-

16. A standard way of quantifying general wrong-way risk is to design and apply stress scenarios that detect wrong-way risk in the portfolio, record counterparty exposures most affected by the scenarios, and assess whether the creditworthiness of such counterparties is also negatively affected by the scenario.

17. Examples of this situation are single-name credit derivatives when there is a legal relationship between the counterparty and the reference entity underlying the transaction, and financing transactions when the counterparty pledges an affiliate's security as collateral.



erally avoid such transactions because of their increased risk);

- perform wrong-way risk analysis for OTC derivatives, at least at the industry and regional levels; and
- conduct wrong-way risk analysis for SFTs on broad asset classes of securities (for example, government bonds, and corporate bonds).

## SYSTEMS INFRASTRUCTURE CONSIDERATIONS

Banking organizations should ensure that systems infrastructure keeps up with changes in the size and complexity of their CCR exposures, and the OTC derivatives market in general. Systems should capture and measure the risk of transactions that may be subject to CCR as a fundamental part of the CCR-management framework.

Banking organizations should have strong operational processes across all derivatives markets, consistent with supervisory and industry recommendations.<sup>18</sup> Management should strive for a single comprehensive CCR-exposure measurement platform.<sup>19</sup> If not currently possible, banking organizations should minimize the number of system platforms and methodologies, as well as manual adjustments to exposure calculations. When using multiple exposure measurement systems, management should ensure that transactions whose future values are measured by different systems are aggregated conservatively.

To maintain a systems infrastructure that supports adequate CCR management, banking organizations should take the following actions:

### *Data Integrity and Reconciliation*

- Deploy adequate operational resources to sup-

18. Examples are recommendations made by the Senior Supervisors Group (a group comprised of senior financial supervisors from ten countries) and the Counterparty Risk Management Policy Group (a group that consists of major, internationally active commercial and investment banks, which works to promote enhanced practices in counterparty credit and market-risk management).

19. A single platform may, in practice, contain a number of separate systems and models. These would be considered a cohesive framework if they are operationally stable and accurate in risk estimation, particularly with regard to proper reflection of collateral and netting. A common programming language for these systems facilitates an effective measurement framework.

port reconciliations and related analytical and remediation processes.

- Reconcile positions and valuations with counterparties.
  - Large counterparties should perform frequent reconciliations of positions and valuations (daily if appropriate).<sup>20</sup>
  - For smaller portfolios with nondealer counterparties where there are infrequent trades, large dealers should ensure the data integrity of trade and collateral information on a regular (but not necessarily daily) basis, reconciling their portfolios according to prevailing industry standards.
- Reconcile exposure data in CCR systems with the official books and records of the financial institution.
- Maintain controls around obligor names at the point of trade entry, as well as reviews of warehoused credit data, to ensure that all exposures to an obligor are captured under the proper name and can be aggregated accordingly.
- Maintain quality control over transfer of transaction information between trade capture systems and exposure measurement systems.
- Harmonize netting and collateral data across systems to ensure accurate collateral calls and reflection of collateral in all internal systems. Banking organizations should maintain a robust reconciliation process to ensure that internal systems have terms that are consistent with those formally documented in agreements and credit files.
- Remediate promptly any systems weaknesses that raise questions about the appropriateness of the limits structure. If there are a significant number of limit excesses, this may be a symptom of system weaknesses, which should be identified and promptly remediated.
- Eliminate or minimize backlogs of unconfirmed trades.

### *Automation and Tracking*

- Automate legal and operational information, such as netting and collateral terms. Banking organizations should be able to adjust exposure measurements, taking into account the enforceability of legal agreements.

20. Large dealer counterparties should perform portfolio reconciliation on a daily basis, as set forth in relevant industry standards, such as the ISDA's "Collateralised Portfolio Reconciliation Best Operational Practices" (January 2010).

- Automate processes to track and manage legal documentation, especially when there is a large volume of legal agreements.
- Increase automation of margin processes<sup>21</sup> and continue efforts to expand automation of OTC derivatives post-trade processing. This should include automation of trade confirmations to reduce the lag between trade execution and legal execution.
- Maintain systems that track and monitor changes in credit terms and have triggers for relevant factors, such as net asset value, credit rating, and cross-default.
- Maintain default monitoring processes and systems.

### Add-Ons

For large derivatives market participants, certain trades may be difficult to capture in exposure-measurement systems, and are therefore modeled outside of the main measurement system(s). The resulting exposures, commonly referred to as add-ons, are then added to the portfolio potential-exposure measure. In limited cases, the use of conservative add-on methodologies may be suitable, if the central system cannot reflect the risk of complex financial products. However, overreliance on add-on methodologies may distort exposure measures. To mitigate measurement distortions, banking organizations should take the following steps:

- Review the use of add-on methodologies at least annually. Current or planned significant trading activity should trigger efforts to develop appropriate modeling and systems, prior to or concurrent with these growth plans.
- Establish growth limits for products with material activities that continue to rely on add-ons. Once systems are improved to meet a generally accepted industry standard of trade capture, these limits can be removed.

21. Banking organizations should consider the recommendations in the “Standards of Electronic Exchange of OTC Derivative Margin Calls,” issued by the ISDA’s Collateral Committee on November 12, 2009.

## RISK MANAGEMENT

### Counterparty Limits

Meaningful limits on exposures are an integral part of a CCR-management framework, and these limits should be formalized in CCR policies and procedures. For limits to be effective, a banking organization should incorporate these limits into an exposure monitoring system independent of relevant business lines. It should perform ongoing monitoring of exposures against such limits, to ascertain conformance with these limits, and have adequate risk controls that require action to mitigate limit exceptions. Review of exceptions should include escalation to a managerial level that is commensurate with the size of the excess or nature of mitigation required. A sound limit system should include the following:

- Establishment and regular review of counterparty limits by a designated committee. Further, a banking organization should have a process to escalate limit approvals to higher levels of authority, depending on the size of counterparty exposures, credit quality, and tenor.
- Establishment of potential future exposure limits, as well as limits based on other metrics. It is a sound practice to limit the market risk arising through CVA, with a limit on CVA or CVA VaR. However, such limits do not eliminate the need to limit counterparty credit exposure with a measure of potential future exposure.
- Individual CCR limits should be based on peak exposures rather than expected exposures.
  - Peak exposures are appropriate for individual counterparty limit monitoring purposes because they represent the risk tolerance for exposure to a single counterparty.
  - Expected exposure is an appropriate measure for aggregating exposures across counterparties in a portfolio credit model, or for use within CVA.
- Consideration of risk factors such as the credit quality of the counterparty, tenor of the transactions, and the liquidity of the positions or hedges.
- Sufficiently automated monitoring processes to provide updated exposure measures at least daily.
- Monitoring of intraday trading activity for

conformance with exposure limits and exception policies. Such controls and procedures can include intraday-limit monitoring, trade procedures and systems that assess a trade's impact on limit utilization prior to execution, limit warning triggers at specific utilization levels, and restrictions by credit-risk management on allocation of full limits to the business lines.

## Margin Policies and Practices

Collateral is a fundamental CCR mitigant. Indeed, significant stress events have highlighted the importance of sound margining practices. With this in mind, banking organizations should ensure that they have adequate margin and collateral "haircut"<sup>22</sup> guidelines for all products with CCR.<sup>23</sup> Accordingly, banking organizations should take the following actions:

- Maintain CCR policies that address margin practices and collateral terms, including, but not limited to
  - processes to establish and periodically review minimum haircuts;
  - processes to evaluate the volatility and liquidity of the underlying collateral. Banks should strive to ensure that haircuts on collateral do not decline during periods of low volatility; and
  - controls to mitigate the potential for a weakening of credit standards from competitive pressure.
- Set guidelines for cross-product margining. Banking organizations offer cross-product-margining arrangements to clients to reduce required margin amounts. Guidelines to control risks associated with cross-product margining would include limiting the set of eligible transactions to liquid exposures and having procedures to resolve margin disputes.
- Maintain collateral-management policies and procedures to control, monitor, and report
  - the extent to which collateral agreements

- expose a banking organization to collateral risks, such as the volatility and liquidity of the securities held as collateral;
- concentrations of less liquid or less marketable collateral asset classes;
- the risks of re-hypothecation or other reinvestment of collateral (both cash and non-cash) received from counterparties, including the potential liquidity shortfalls resulting from the reuse of such collateral; and
- the CCR associated with the decision whether to require posted margin to be segregated. Organizations should perform a legal analysis concerning the risks of agreeing to allow cash to be commingled with a counterparty's own cash and of allowing a counterparty to rehypothecate securities pledged as margin.
- Maintain policies and processes for monitoring margin agreements involving third-party custodians. As with bilateral counterparties, banking organizations should
  - identify the location of the account to which collateral is posted or from which it is received;
  - obtain periodic account statements or other assurances that confirm the custodian is holding the collateral in conformance with the agreement; and
  - understand the characteristics of the account where the collateral is held (for example, whether it is in a segregated account) and the legal rights of the counterparty or any third-party custodian regarding this collateral.

## Validation of Models and Systems

A banking organization should validate its CCR models initially and on an ongoing basis. Validation of models should include an evaluation of the conceptual soundness and developmental evidence supporting a given model; an ongoing monitoring process that includes verification of processes and benchmarking; and an outcomes-analysis process that includes backtesting. Validation should identify key assumptions and potential limitations, and it should assess their possible impact on risk metrics. All components of models should be subject to validation along with their combination in the CCR system.

22. A *haircut* is the difference between the market value of an asset being used as collateral for a loan and the amount of money that a lender will advance against the asset.

23. See the guidelines issued by ISDA, the Securities Industry and Financial Markets Association (SIFMA), and the Managed Funds Association (MFA), including the "Market Review of OTC Derivative Bilateral Collateralization Practices (Release 2.0)" (March 2010), and "Best Practices for Collateral Management" (June 30, 2010).



Evaluating the conceptual soundness involves assessing the quality of the design and construction of the CCR models and systems, including documentation and empirical evidence that supports the theory, data, and methods used.

Ongoing monitoring confirms that CCR systems continue to perform as intended. This generally involves process verification, an assessment of model data integrity and systems operation, and benchmarking to assess the quality of a given model. Benchmarking is a valuable diagnostic tool in identifying potential weaknesses. Specifically, it is the comparison of a banking organization's CCR model estimates with those derived using alternative data, methods, or techniques. Benchmarking can also be applied to particular CCR model components, such as parameter-estimation methods or pricing models. Management should investigate the source of any differences in output, and determine whether benchmarking gaps indicate weaknesses in the banking organization's models.

Outcomes analysis compares model outputs to actual results during a sample period not used in model development. This is generally accomplished using backtesting. It should be applied to components of CCR models (for example, the risk-factor distribution and pricing model), the risk measures, and projected exposures. While there are limitations to backtesting, especially for testing the longer time-horizon predictions of a given CCR model, it is an essential component of model validation. Banking organizations should have a process for the resolution of observed model deficiencies detected by backtesting. This should include further investigation to determine the problem and appropriate course of action, including changing a given CCR model.

If the validation of CCR models and infrastructure systems is not performed by staff that is independent from the developers of the models, then an independent review should be conducted by technically competent personnel to ensure the adequacy and effectiveness of the validation. The scope of the independent review should include validation procedures for all components, the role of relevant parties, and documentation of the model and validation processes. This review should document its results, what action was taken to resolve findings, and its relative timeliness.

Senior management should be notified of validation and review results and should take appropriate and timely corrective actions to

address deficiencies. The board should be apprised of summary results, especially unresolved deficiencies. In support of validation activities, internal audit should review and test models and systems validation as well as overall systems infrastructure as part of their regular audit cycle.

For more information on validation, please see this section's Appendix B.

## Close-Out Policies and Practices

Banking organizations should have the ability to effectively manage counterparties in distress, including execution of a close-out. Policies and procedures outlining sound practices for managing a close-out should include the following:

- Requirements for hypothetical close-out simulations at least once every two years for one of the banking organization's most complex counterparties.
- Standards for the speed and accuracy with which the banking organization can compile comprehensive counterparty exposure data and net cash outflows. Operational capacity to aggregate exposures within four hours is a reasonable standard.
- The sequence of critical tasks, and decision-making responsibilities, needed to execute a close-out.
- Requirements for periodic review of documentation related to counterparty terminations, and confirmation that appropriate and current agreements that specify the definition of events of default and the termination methodology that will be used are in place.
  - Banking organizations should take corrective action if documents are not current, active, and enforceable.
  - Management should document their decision to trade with counterparties that are either unwilling or unable to maintain appropriate and current documentation.
- Established close-out methodologies that are practical to implement, particularly with large and potentially illiquid portfolios. Dealers should consider using the "close-out amount" approach for early termination upon default in interdealer relationships.<sup>24</sup>

<sup>24</sup> Only for a definition of *close-out amount approach*, see the Counterparty Risk Management Policy Group III's report, "Containing Systemic Risk: Road to Reform" (August 6,

- A requirement that the banking organization transmit immediate instructions to its appropriate transfer agent(s) to deactivate collateral transfers, contractual payments, or other automated transfers contained in “standard settlement instructions” for counterparties or prime brokers that have defaulted on the contract or for counterparties or prime brokers that have declared bankruptcy.

## MANAGING CENTRAL COUNTERPARTY EXPOSURES

A central credit counterparty (CCP) facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts, and typically requires all participants to be fully collateralized on a daily basis. The CCP thus effectively bears most of the counterparty credit risk in transactions, becoming the buyer for every seller and the seller to every buyer. Well-regulated and soundly managed CCPs can be an important means of reducing bilateral counterparty exposure in the OTC derivatives market. However, CCPs also concentrate risk within a single entity. Therefore, it is important that banking organizations centrally clear through regulated CCPs with sound risk-management processes and strong financial resources sufficient to meet their obligations under extreme stress conditions.

To manage CCP exposures, banking organizations should regularly, but no less frequently than annually, review the individual CCPs to which they have exposures. This review should include performing and documenting due diligence on each CCP, applying current supervisory or industry standards<sup>25</sup> (and any subsequent standards) as a baseline to assess the CCP’s risk-management practices.

- For each CCP, an evaluation of its risk-management framework should, at a minimum, include membership require-

ments, guarantee fund contributions, margining practices, default-sharing protocols, and limits of liability.

- Banking organizations should also consider the soundness of the CCP’s policies and procedures, including procedures for handling the default of a clearing member, obligations at post-default auctions, and post-default assignment of positions.
- Banking organizations should also maintain compliance with applicable regulatory requirements, such as ensuring contingent loss exposure remains within a banking organization’s legal lending limit.

## LEGAL AND OPERATIONAL RISK MANAGEMENT

Banking organizations should ensure proper control of, and access to, legal documentation and agreements. In addition, it is important that systems used to measure CCR incorporate accurate legal terms and provisions. The accessibility and accuracy of legal terms is particularly critical in close-outs, when there is limited time to review the collateral and netting agreements. Accordingly, banking organizations should

- Have a formal process for negotiating legal agreements. As a best practice, the process would include approval steps and responsibilities of applicable departments.
- At least annually, conduct a review of the legal enforceability of collateral and netting agreements for all relevant jurisdictions.
- Maintain policies on when it is acceptable to trade without a master agreement,<sup>26</sup> using metrics such as trading volume or the counterparty’s risk profile.
  - Trading without a master agreement may be acceptable in cases of minimal volume or when trading in jurisdictions where master agreements are unenforceable. As applicable, policies should outline required actions to undertake and monitor transactions without an executed master agreement.

2008), pp. 122–125. Also, ISDA has published a closeout amount protocol to aid in the adoption of the close-out amount approach.

25. For instance, see “Recommendations for Central Counterparties,” a consultative report issued by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions under the auspices of the Bank for International Settlements (March 2004).

26. The capital rules in the United States refer to master agreements. These include the Federal Reserve’s “Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II,” 12 CFR 208, Appendix F, and 12 CFR 225, Appendix G. For the FDIC, it is 12 CFR 325, Appendix D. For the OCC, see 12 CFR Part 3, Appendix C.

- Use commonly recognized dispute-resolution procedures.<sup>27</sup>
    - Banking organizations should seek to resolve collateral disputes within recommended time frames.
    - Senior management should receive reports listing material and aged disputes, as these pose significant risk.
  - Include netting of positions in risk-management systems, only if there is a written legal review (either internally or externally) that expresses a high level of confidence that netting agreements are legally enforceable.
  - Maintain ongoing participation in both bilateral and multilateral portfolio-compression efforts. Where feasible, banking organizations are encouraged to elect compression tolerances (such as post-termination factor sensitivity changes and cash payments) that allow the widest possible portfolio of trades to be terminated.
  - Adopt and implement appropriate novation protocols.<sup>28</sup>
- investment objectives, and financial condition.
    - For example, although some clients may be sophisticated enough to enter into a standardized swap, they may lack the sophistication to fully analyze the risks of a complex OTC deal.
    - Banking organizations should be particularly careful to assess appropriateness of complex, long-dated, off-market, illiquid, or other transactions with higher reputational risk.
  - Include appropriateness assessments in the new-product approval process. Such assessments should determine the types of counterparties acceptable for a new product, and what level of counterparty sophistication is required for any given product.
  - Maintain disclosure policies for OTC derivative and other complex transactions to ensure that risks are accurately and completely communicated to counterparties.
  - Maintain guidelines for determination of acceptable counterparties for complex derivatives transactions.

### Legal Risk Arising from Counterparty Appropriateness<sup>29</sup>

While a counterparty's ability to pay should be evaluated when assessing credit risk, credit losses can also occur when a counterparty is unwilling to pay, which most commonly occurs when a counterparty questions the appropriateness of a contract. These types of disputes pose not only risk of a direct credit loss, but also risk of litigation costs and/or reputational damage. Banking organizations should maintain policies and procedures to assess client and deal appropriateness. In addition, banking organizations should

- Conduct initial and ongoing due diligence, evaluating whether a client is able to understand and utilize transactions with CCR as part of assessing the client's sophistication,

27. An example of such procedures would be the ISDA's "2009 Dispute Resolution Protocol" (September 2009).

28. An example would be the ISDA's novation protocol.

29. For guidance on counterparty appropriateness, see section 4033.1 of this manual; section 2128.09 in the *Bank Holding Company Supervision Manual*; section 2070 of the *Trading and Capital-Markets Activities Manual*; and SR-07-5, "Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities" (January 11, 2007).

### CONCLUSION ON COUNTERPARTY CREDIT-RISK MANAGEMENT

For relevant banking organizations, CCR management should be an integral component of the risk-management framework. When considering the applicability of specific guidelines and best practices set forth in this guidance, a banking organization's senior management and supervisors should consider the size and complexity of its securities and trading activities. Banking organizations should comprehensively evaluate existing practices against the standards in this guidance and implement remedial action as appropriate. A banking organization's CCR exposure levels and the effectiveness of its CCR management are important factors for a supervisor to consider when evaluating a banking organization's overall management, risk management, and credit- and market-risk profile.

### APPENDIX A: GLOSSARY

This glossary describes commonly used CCR metrics. As discussed above, banking organizations should employ a suite of metrics commensurate with the size, complexity, liquidity, and

risk profile of the organization's CCR portfolio. Major broker-dealer banking organizations should employ the full range of risk-measurement metrics to enable a comprehensive understanding of CCR and how it changes in varying environments. Banking organizations of lesser size and complexity should carefully consider which of these metrics they need to track as part of their exposure risk-management processes. At a minimum, all banking organizations should calculate current exposure and stress test their CCR exposures. Definitions marked with an asterisk (\*) are from the Bank for International Settlements.

## Exposure Metrics

*Current exposure* is the larger of zero, or the market value of a transaction or a portfolio of transactions within a netting set with a counterparty that would be lost upon the default of the counterparty, assuming no recovery on the value of those transactions in bankruptcy. Current exposure is often also called replacement cost. Current exposure may be reported gross or net of collateral. Current exposure allows banking organizations to assess their CCR exposure at any given time—that is, the amount currently at risk.

*Jump-to-default (JTD) exposure* is the change in the value of counterparty transactions upon the default of a reference name in CDS positions. This allows banking organizations to assess the risk of a sudden, unanticipated default before the market can adjust.

*Expected exposure* is calculated as average exposure to a counterparty at a date in the future. This is often an intermediate calculation for expected positive exposure or CVA. It can also be used as a measure of exposure at a common time in the future.

*Expected positive exposure (EPE)* is the weighted average over time of expected exposures when the weights are the proportion that an individual expected exposure represents of the entire time interval. Expected positive exposure is an appropriate measure of CCR exposure when measured in a portfolio credit-risk model.\*

*Peak exposure* is a high percentile (typically

95 percent or 99 percent) of the distribution of exposures at any particular future date before the maturity date of the longest transaction in the netting set. A peak exposure value is typically generated for many future dates up until the longest maturity date of transactions in the netting set. Peak exposure allows banking organizations to estimate their maximum potential exposure at a specified future date, or over a given time horizon, with a high level of confidence. For collateralized counterparties, this metric should be based on a realistic close-out period, considering both the size and liquidity of the portfolio. Banking organizations should consider peak potential exposure when setting counterparty credit limits.\*

*Expected shortfall exposure* is similar to peak exposure, but is the expected exposure conditional on the exposure being greater than some specified peak percentile. For transactions with very low probability of high exposure, the expected shortfall accounts for large losses that may be associated with transactions with high-tail risk.

*Sensitivity to market risk factors* is the change in exposure because of a given market-risk-factor change (for example, a position's change in price resulting from a 1 basis point change in interest rates). It provides information on the key drivers of exposure to specific counterparties and on hedging.

*Stressed exposure* is a forward-looking measure of exposure based on predefined market-factor movements (nonstatistically generated). These can include single-factor market shocks, historical scenarios, and hypothetical scenarios. Stressed exposure allows banking organizations to consider their counterparty exposure under a severe or stressed scenario. This serves as a supplemental view of potential exposure, and provides banking organizations with additional information on risk drivers. The best practice is to compare stressed exposure to counterparty credit limits.

## CVA-Related Metrics

*Credit valuation adjustment (CVA)* is an adjustment to the mid-market valuation (average of the bid and asked price) of the portfolio of

trades with a counterparty. This adjustment reflects the market value of the credit risk resulting from any failure to perform on contractual agreements with a counterparty. This adjustment may reflect the market value of the credit risk of the counterparty or the market value of the credit risk of both the banking organization and the counterparty. CVA is a measure of the market value of CCR, incorporating both counterparty creditworthiness and the variability of exposure.\*

*CVA VaR* is a measure of the variability of the CVA mark-to-market value and is based on the projected distributions of both exposures and counterparty creditworthiness. CVA VaR provides banking organizations with an estimate of the potential CVA mark-to-market loss, at a certain confidence interval and over a given time horizon.

*CVA factor sensitivities* is the mark-to-market change in CVA resulting from a given market-risk-factor change (for example, a position's change in price resulting from a 1 basis point change in credit spreads). CVA factor sensitivities allow banking organizations to assess and hedge the market value of the credit or market risks to single names and portfolios and permit banking organizations to monitor excessive build ups in counterparty concentrations.

*Stressed CVA* is a forward-looking measure of CVA mark-to-market value based on predefined credit- or market-factor movements (nonstatistically generated). These can include single-market-factor shocks, historical scenarios, and hypothetical scenarios. Stressed CVA serves as an informational tool and allows banking organizations to assess the sensitivity of their CVA to a potential mark-to-market loss under defined scenarios.

## APPENDIX B: DETAIL ON MODEL VALIDATION AND SYSTEMS EVALUATION

A banking organization should validate its CCR models, initially and on an ongoing basis. Validation should include three components: (1) an evaluation of the conceptual soundness of relevant models (including developmental evidence); (2) an ongoing monitoring process that

includes verification of processes and benchmarking; and (3) an outcomes-analysis process that includes backtesting. The validation should either be independent or subject to independent review.

Validation is the set of activities designed to give the greatest possible assurances of CCR models' accuracy and systems' integrity. Validation should also identify key assumptions and potential limitations and assess their possible impact on risk metrics. CCR models have several components:

- statistical models to estimate parameters, including the volatility of risk factors and their correlations
- simulation models to convert those parameters into future distributions of risk factors
- pricing models that estimate value in simulated scenarios
- calculations that summarize the simulation results into various risk metrics

All components of each model should be subject to validation, along with analysis of their interaction in the CCR system. Validation should be performed initially when a model first goes into production. Ongoing validation is a means of addressing situations where models have known weaknesses and ensuring that changes in markets, products, or counterparties do not create new weaknesses. Senior management should be notified of the validation results and should take corrective actions in a timely manner when appropriate.

A banking organization's validation process should be independent of the CCR model and systems development, implementation, and operation. Alternately, the validation should be subject to independent review, whereby the individuals who perform the review are not biased in their assessment because of involvement in the development, implementation, or operation of the processes or products. Individuals performing the reviews should possess the requisite technical skills and expertise to provide critical analysis, effective challenge, and appropriate recommendations. The extent of such reviews should be fully documented, sufficiently thorough to cover all significant model elements, and include additional testing of models or systems as appropriate. In addition, reviewers should have the authority to effectively challenge developers and model users, elevate concerns or findings as necessary, and either

have issues addressed in a prompt and substantial manner or reject a model for use by the banking organization.

## Conceptual Soundness and Developmental Evidence

The first component of validation is evaluating conceptual soundness, which involves assessing the quality of the design and construction of CCR models. The evaluation of conceptual soundness includes documentation and empirical evidence supporting the theory, data, and methods used. The documentation should also identify key assumptions and potential limitations and assess their possible impact. A comparison to industry practice should be done to identify areas where substantial and warranted improvements can be made. All model components are subject to evaluation, including simplifying assumptions, parameter calibrations, risk-factor diffusion processes, pricing models, and risk metrics. Developmental evidence should be reviewed whenever the banking organization makes material changes in CCR models. Evaluating conceptual soundness includes independent evaluation of whether a model is appropriate for its purpose and whether all underlying assumptions, limitations, and shortcomings have been identified and their potential impact assessed.

## Ongoing Monitoring, Process Verification, and Benchmarking

The second component of model validation is ongoing monitoring to confirm that the models were implemented appropriately and continue to perform as intended. This involves process verification, an assessment of models, and benchmarking to assess the quality of the model. Deficiencies uncovered through these activities should be remediated promptly.

Process verification includes evaluating data integrity and operational performance of the systems supporting CCR measurement and reporting. This should be performed on an ongoing basis and includes

- the completeness and accuracy of the transaction and counterparty data flowing through the counterparty exposure systems;

- reliance on up-to-date reviews of the legal enforceability of contracts and master netting agreements that govern the use of netting and collateral in systems measuring net exposures and the accuracy of their representations in the banking organization's systems;
- the integrity of the market data used within the banking organization's models, both as current values for risk factors and as sources for parameter calibrations; and
- the operational performance of the banking organization's counterparty exposure calculation systems, including the timeliness of the batch-run calculations, the consistent integration of data coming from different internal or external sources, and the synchronization of exposure, collateral management, and finance systems.

“Benchmarking” means comparing a banking organization's CCR measures with those derived using alternative data, methods, or techniques. It can also be applied to particular model components, such as parameter estimation methods or pricing models. It is an important complement to backtesting and is a valuable diagnostic tool in identifying potential weaknesses. Differences between the model and the benchmark do not necessarily indicate that the model is in error because the benchmark itself is an alternative prediction. It is important that a banking organization use appropriate benchmarks, or the exercise will be compromised. As part of the benchmarking exercise, the banking organization should investigate the source of the differences and whether the extent of the differences is appropriate.

## Outcomes Analysis Including Backtesting

The third component of validation is outcomes analysis, which is the comparison of model outputs to actual results during a sample period not used in model development. Backtesting is one form of out-of-sample testing. Backtesting should be applied to components of a CCR model, for example the risk factor distribution and pricing model, as well as the risk measures and projected exposures. Outcomes analysis includes an independent evaluation of the design and results of backtesting to determine whether all material risk factors are captured and to



assess the accuracy of the diffusion of risk factors and the projection of exposures. While there are limitations to backtesting, especially for testing the longer horizon predictions of a CCR model, banking organizations should incorporate it as an essential component of model validation.

Typical examples of CCR models that require backtesting are expected exposure, peak exposure, and CVA VaR models. Backtesting of models used for measurement of CCR is substantially different than backtesting VaR models for market risk. Notably, CCR models are applied to each counterparty facing the banking organization, rather than an aggregate portfolio. Furthermore, CCR models should project the distribution over multiple dates and over long time horizons for each counterparty. These complications make the interpretation of CCR backtesting results more difficult than that for market risk. Because backtesting is critical to providing feedback on the accuracy of CCR models, it is particularly important that banking organizations exert considerable effort to ensure that backtesting provides effective feedback on the accuracy of these models.

Key elements of backtesting include the following activities:

- Backtesting programs should be designed to evaluate the effectiveness of the models for typical counterparties, key risk factors, key correlations, and pricing models. Backtesting results should be evaluated for reasonableness as well as for statistical significance. This may serve as a useful check for programming errors or cases in which models have been incorrectly calibrated.
- Backtesting should be performed over different time horizons. For instance, the inclusion of mean reversion parameters or similar time varying features of a model can cause a model to perform adequately over one time horizon, but perform very differently over a different time horizon. A typical large dealer should, at a minimum, perform backtesting over one day, one week, two weeks, one month, and every quarter out to a year. Shorter time periods may be appropriate for transactions under a collateral agreement when variation margin is exchanged frequently, even daily, or for portfolios that contain transactions that expire or mature in a short time frame.
- Backtesting should be conducted on both real counterparty portfolios and hypothetical portfolios. Backtesting on fixed hypothetical portfolios provides the opportunity to tailor backtesting portfolios to identify whether particular risk factors or correlations are modeled correctly. In addition, the use of hypothetical portfolios is an effective way to meaningfully test the predictive abilities of the counterparty exposure models over long time horizons. Banking organizations should have criteria for their hypothetical portfolios. The use of real counterparty portfolios evaluates whether the models perform on actual counterparty exposures, taking into account portfolio changes over time.

It may be appropriate to use backtesting methods that compare forecast distributions of exposures with actual distributions. Some CCR measures depend on the whole distribution of future exposures rather than a single exposure percentile—for example, expected exposure (EE) and expected positive exposure (EPE). For this reason, sole reliance on backtesting methods that count the number of times an exposure exceeds a unique percentile threshold may not be appropriate.

Exception counting remains useful, especially for evaluating peak or percentile measures of CCR, but these measures will not provide sufficient insight for expected exposure measures. Hence, banking organizations should test the entire distribution of future exposure estimates and not just a single percentile prediction.

Banking organizations should have policies and procedures in place that describe when backtesting results will generate an investigation into the source of observed backtesting deficiencies and when model changes should be initiated as a result of backtesting.

## Documentation

Adequate validation and review are contingent on complete documentation of all material aspects of CCR models and systems. This should include all model components and parameter estimation or calibration processes. Documentation should also include the rationale for all material assumptions underpinning its chosen analytical frameworks, including the

choice of inputs; distributional assumptions; and weighting of quantitative and qualitative elements. Any subsequent changes to these assumptions should also be documented and justified.

The validation or independent review should be fully documented. Specifically, this would include results, the scope of work, conclusions and recommendations, and responses to those recommendations. This includes documentation of each of the three components of model validation, discussed above. Complete documentation should be done initially and updated over time to reflect ongoing changes and model performance. Ability of the validation (or review) to provide effective challenge should also be documented.

### Internal Audit

A banking organization should have an internal audit function, independent of business-line man-

agement, which assesses the effectiveness of the model validation process. This assessment should ensure the following: proper validation procedures were followed for all components of the CCR model and infrastructure systems; required independence was maintained by validators or reviewers; documentation was adequate for the model and validation processes; and results of validation procedures are elevated, with timely responses to findings. Internal audit should also evaluate systems and operations that support CCR. While internal audit may not have the same level of expertise as quantitative experts involved in the development and validation of the model, they are particularly well suited to evaluate process verification procedures. If any validation or review work is outsourced, internal audit should evaluate whether that work meets the standards discussed in this section.



A bank operates as a securities dealer when it underwrites, trades, or deals in securities. These activities may be administered in a separately identifiable trading department or incorporated within the overall treasury department. The organizational structure will generally be a function of the level of activity and the importance of the activity as a product line. If a repetitive pattern of short-term purchases and sales demonstrates that the bank holds itself out to other dealers or investors as a securities dealer, the bank is trading, regardless of what department or section of the bank is engaged in the activity.

The authority under which a bank may engage in securities trading and underwriting is found in section 5136 of the Revised Statutes (12 USC 24 (seventh)). That authority is restricted by limitations on the percentage holding of classes of securities as found in 12 CFR 1.3. This regulation allows banks to deal, underwrite, purchase, and sell (1) type I securities without limit and (2) type II securities subject to a limit of 10 percent of capital and unimpaired surplus per issue. Banks are prohibited from underwriting or dealing in type III securities for their own accounts. See section 2020.1, "Investment Securities and End-User Activities," for further information on types I, II, and III securities.

Banks are involved in three major types of securities transactions. First, the bank, acting as broker, buys and sells securities on behalf of a customer. These are agency transactions in which the agent (bank) assumes no substantial risk and is compensated by a prearranged commission or fee. A second type of securities transaction banks frequently execute is a "riskless-principal" trade. Upon the order of an investor, the dealer buys (or sells) securities through its own account, with the purchase and sale originating almost simultaneously. Because of the brief amount of time the security is held in the dealer's own account, exposure to market risks is limited. Profits result from dealer-initiated markup (the difference between the purchase and sale prices). Finally, as a dealer, the bank buys and sells securities for its own account. This is termed a principal transaction because the bank is acting as a principal, buying or selling qualified securities through its own inventory and absorbing whatever market gain or loss is made on the transaction.

The volume of bank dealer activity and the dealer's capacity in the transaction are critical to an examiner's assessment regarding the examination scope and the required examiner resources and expertise. Dealers engaging primarily in agency or riskless-principal transactions are merely accommodating customers' investment needs. Market risk will be nominal, and the key examination concern will be operational risk and efficiency. Active dealers generally carry larger inventory positions and may engage in some degree of proprietary trading. Their market-risk profile may be moderate to high.

Bank dealers' securities transactions involve customers and other securities dealers. The word "customer," as used in this section, means an investor. Correspondent banks purchasing securities for an investment account would also be considered a customer. Transactions with other dealers are not considered customer transactions unless the dealer is buying or selling for investment purposes.

The following subsections include general descriptions of significant areas of bank trading and underwriting activities. Foreign exchange is covered in detail in the "International" sections of this manual. Additional bank dealer activities, particularly in derivative products, are extensively covered in the *Trading and Capital-Markets Activities Manual*. In addition, many money-center banks and larger regional banks have transferred dealing activities to separately capitalized holding company subsidiaries (known as underwriting affiliates). The *Bank Holding Company Supervision Manual* contains a separate section on nonbank subsidiaries engaged in underwriting and dealing in bank-ineligible securities.

## OVERVIEW OF RISK

For bank dealer activities, risk is generally defined as the potential for loss on an instrument or portfolio. Significant risk can also arise from operational weakness and inadequate controls. Risk management is the process by which managers identify, assess, and control all risks associated with a financial institution's activities. The increasing complexity of the financial industry and the range of financial instruments banks use have made risk management more difficult to accomplish and evaluate.

The four fundamental elements for evaluating the risk-management process for bank dealer activities are—

- active board and management oversight,
- adequate risk-management policies and limits,
- appropriate risk measurement and management information systems, and
- comprehensive internal controls and audit procedures.

For risk management to be effective, an institution's board and senior management must be active participants in the process. They must ensure that adequate policies and risk-tolerance limits are developed for managing the risk in bank dealer activities, and they must understand, review, and approve these limits across all established product lines. For policies and limits to be effective and meaningful, risk measures, reports, and management information systems must provide management and the board with the information and analysis necessary to make timely and appropriate responses to changing conditions. Risk management must also be supported by comprehensive internal controls and audit procedures that provide appropriate checks and balances to maintain an ongoing process of identifying any emerging weaknesses in an institution's management of risk.<sup>1</sup> At a minimum, the effectiveness of the institution's policies, limits, reporting systems, and internal controls must be reviewed annually.

In assessing the adequacy of the above elements at individual institutions, examiners should consider the nature and volume of a bank's dealer activities and its overall approach toward managing the various types of risks involved. The sophistication or complexity of policies and procedures used to manage risk depends on the bank dealer's chosen products, activities, and lines of business. Accordingly, examiners should expect risk-management activities to differ among institutions.

As a financial institution's product offerings and geographic scope expand, examiners must review the risk-management process not only by business line, but on a global, consolidated

basis. In more sophisticated institutions, the role of risk management is to identify the risks associated with particular business activities and to aggregate summary data into generic components, ultimately allowing exposures to be evaluated on a common basis. This methodology enables institutions to manage risks by portfolio and to consider exposures in relationship to the institution's global strategy and risk tolerance.

A review of the global organization may reveal risk concentrations that are not readily identifiable from a limited, stand-alone evaluation of a branch, agency, Edge Act institution, nonbank subsidiary, or head office. Consolidated risk management also allows the institution to identify, measure, and control its risks, while giving necessary consideration to the breakdown of exposure by legal entity. Sometimes, if applicable rules and laws allow, identified risks at a branch or subsidiary may be offset by exposures at another related institution. However, risk management across separate entities must be done in a way that is consistent with the authorities granted to each entity. Some financial institutions and their subsidiaries may not be permitted to hold, trade, deal, or underwrite certain types of financial instruments unless they have received special regulatory approval. Examiners should ensure that a financial institution only engages in those activities for which it has received regulatory approval. Furthermore, examiners should verify that the activities are conducted in accordance with any Board conditions or commitments attached to the regulatory approval.

Ideally, an institution should be able to identify its relevant generic risks and should have measurement systems in place to quantify and control these risks. While it is recognized that not all institutions have an integrated risk-management system that aggregates all business activities, the ideal management tool would incorporate a common measurement denominator. Risk-management methodologies in the marketplace and an institution's scope of business are continually evolving, making risk management a dynamic process. Nonetheless, an institution's risk-management system should always be able to identify, aggregate, and control all risks posed by underwriting, trading, or dealing in securities that could have a significant impact on capital or equity.

Trading and market-risk limits should be customized to address the nature of the products

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1. Existing policies and examiner guidance on various topics applicable to the evaluation of risk-management systems can be found in SR-93-69, "Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations." Many of the managerial and examiner practices contained in this document are fundamental and are generally accepted as sound practices for trading activities.

and any unique risk characteristics. Common types of limits include earnings-at-risk limits, stop-loss limits, limits on notional amounts (both gross and duration-weighted), maturity limits, and maturity-gap limits. The level of sophistication needed within the limit matrix will depend on the type of instrument involved and the relative level of trading activity. Straight-forward notional and tenor limits may be adequate for most dealers; however, dealers involved in a wide array of products and more complex transactions will need stronger tools to measure and aggregate risk across products.

In general, risk from trading and dealing activities can be broken down into the following categories:

- Market or price risk is the exposure of an institution's financial condition to adverse movements in the market rates or prices of its holdings before such holdings can be liquidated or expeditiously offset. It is measured by assessing the effect of changing rates or prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution.
- Funding-liquidity risk refers to the ability to meet investment and funding requirements arising from cash-flow mismatches.
- Market-liquidity risk refers to the risk of being unable to close out open positions quickly enough and in sufficient quantities at a reasonable price.
- Credit risk is the risk that a counterparty to a transaction will fail to perform according to the terms and conditions of the contract, thus causing the security to suffer a loss in cash-flow or market value. Because securities settlements are typically "delivery vs. payment" and settlement periods are relatively short, securities transactions do not involve a significant level of counterparty credit risk. Repurchase transactions, securities lending, and money market transactions, however, involve significantly higher levels of credit risk if not properly controlled. As a result, credit risk is discussed in greater detail in the subsections addressing these products. Credit risk can also arise from positions held in trading inventory. Although U.S. government and agency securities do not generally involve credit risk, other securities (for example, municipal and corporate securities) carried in inventory can decline in price due to a deterioration in credit quality.
- Clearing or settlement risk is (1) the risk that a counterparty who has received a payment or delivery of assets defaults before delivery of the asset or payment or (2) the risk that technical difficulties interrupt delivery or settlement despite the counterparty's ability or willingness to perform.
- Operations and systems risk is the risk of human error or fraud, or the risk that systems will fail to adequately record, monitor, and account for transactions or positions.
- Legal risk is the risk that a transaction cannot be consummated as a result of some legal barrier, such as inadequate documentation, a regulatory prohibition on a specific counterparty, non-enforceability of bilateral and multilateral close-out netting, or collateral arrangements in bankruptcy.

The *Trading and Capital-Markets Activities Manual* contains a comprehensive discussion of these risks, including examination objectives, procedures, and internal control questionnaires by risk category.

## GOVERNMENT AND AGENCY SECURITIES

The government securities market is dominated by a number of investment banks, broker-dealers, and commercial banks known as primary dealers in government securities. These dealers make an over-the-counter market in most government and federal-agency securities. Primary dealers are authorized to deal directly with the Open Market Desk of the Federal Reserve Bank of New York. As market makers, primary dealers quote bid-ask prices on a wide range of instruments, and many publish daily quotation sheets or provide live electronic data feeds to larger customers or other dealers.

Government securities trading inventories are generally held with the objective of making short-term gains through market appreciation and dealer-initiated markups. Common factors that affect the markup differential include the size of a transaction, the dealer efforts extended, the type of customer (active or inactive), and the nature of the security. Markups on government securities generally range between  $\frac{1}{32}$  and  $\frac{4}{32}$  of a point. Long-maturity issues or derivative products may have higher markups due to the higher risk and potentially larger volatility that may be

inherent in these products.

According to industry standards, payments for and deliveries of U.S. government and most agency securities are settled one business day following the trade date, although government dealers and customers can negotiate same-day or delayed settlement for special situations.

## When-Issued Trading

A significant potential source of risk to dealers involves “when-issued” (WI) trading in government securities. WI trading is the buying and selling of securities in the one- to two-week interim between the announcement of an offering and the security auction and settlement. Although the vast majority of transactions settle on the next business day, WI trading results in a prolonged settlement period. This could increase both the market risk and counterparty credit risk associated with trading these instruments. The prolonged settlement period also provides an opportunity for a dealer to engage in a large volume of off-balance-sheet trading without having to fund the assets or cover the short positions. In essence, WI trading allows the dealers to create securities. If the overall level of WI trading is significant in relation to the size of the issue, the resulting squeeze on the market could increase volatility and risk. Given these potential risk characteristics, WI trading should be subject to separate sublimits to cap the potential exposure.

## Short Sales

Another area of U.S. government securities activity involves short-sale transactions. A short sale is the sale of a security that the seller does not own at the time of the sale. Delivery may be accomplished by buying the security or by borrowing the security. When the security delivered is borrowed, the short seller likely will ultimately have to acquire the security in order to satisfy its repayment obligation. The borrowing transaction is collateralized by a security (or securities) of similar value or cash (most likely the proceeds of the short sale). Reverse repurchase transactions are also used to obtain the security needed to make delivery on the security sold short. Carrying charges on borrowed government securities should be deducted from the short sale and purchase spread to determine net

profit. Short sales are conducted to (1) accommodate customer orders, (2) obtain funds by leveraging existing assets, (3) hedge the market risk of other assets, or (4) allow a dealer to profit from a possible future decline in market price by purchasing an equivalent security at a later date at a lower price.

## Government Securities Clearing

Securities-clearing services for the bulk of U.S. government securities transactions and many federal-agency securities transactions are provided by the Federal Reserve as part of its electronic securities-transfer system. The various Federal Reserve Banks will wire-transfer most government securities between the book-entry safekeeping accounts of the seller and buyer. The Federal Reserve’s systems are also used to facilitate security borrowings, loans, and pledges.

## Government Securities Act

In response to the failures of a number of unregulated government securities dealers between 1975 and 1985, Congress passed the Government Securities Act of 1986 (GSA). GSA established, for the first time, a federal system for the regulation of the entire government securities market, including previously unregulated brokers and dealers. The primary goal of GSA was to protect investors and ensure the maintenance of a fair, honest, and liquid market.

The GSA granted the Department of the Treasury (Treasury) authority to develop and implement rules for transactions in government and agency securities effected by government securities brokers or dealers (that is, securities firms as well as other financial institutions), and to develop and implement regulations relating to the custody of government securities held by depository institutions. The rules were intended to prevent fraudulent and manipulative acts and practices and to protect the integrity, liquidity, and efficiency of the government securities market. At the same time, the rules were designed to preclude unfair discrimination among brokers, dealers, and customers. Enforcement of the rules for the GSA is generally carried out by an institution’s primary regulatory organization.

The rules for the GSA had the most significant effect on those entities that were not previously subject to any form of federal registration and regulation. These entities included not only firms registered as government securities brokers or dealers but also firms registered as brokers or dealers trading in other securities and financial products. For the first time, the government securities activities of these entities were subject to the discipline of financial responsibility, customer protection, recordkeeping, and advertising requirements. For nonbank dealers, this regulation is enforced by a self-regulatory organization, the Financial Industry Regulatory Authority (FINRA), which conducts routine examinations under the oversight of the Securities and Exchange Commission (SEC).

The provisions of the GSA that had the most significant effect on government securities brokers and dealers (both bank and nonbank broker-dealers) relate to hold-in-custody repurchase agreement rules. Congress targeted this area because of abuses that had resulted in customer losses. Several requirements to strengthen customer protection were imposed: (1) written repurchase agreements must be in place, (2) the risks of the transactions must be disclosed to the customer, (3) specific repurchase securities must be allocated to and segregated for the customer, and (4) confirmations must be made and provided to the customer by the end of the day on which a transaction is initiated and on any day on which a substitution of securities occurs. For a more detailed description of the rules for the GSA requirements, see the procedures for the examination of government securities activities issued by the Board of Governors of the Federal Reserve System, or 17 CFR 400–450 for the actual text of the regulations.

## Registration Exemptions

Most banks acting as government securities brokers or dealers are required to file a form known as a G-FIN. This form details the bank's capacity, the locations where government securities activities are performed, and the persons responsible for supervision. However, certain bank government securities activities are exempt from the filing requirements. Banks handling only U.S. savings bond transactions or submitting tender offers on original issue

U.S. Treasury securities are exempt from registration.

Limited government securities brokerage activities are also exempt from registration under certain circumstances. Banks that engage in fewer than 500 government securities transactions annually (excluding savings bond transactions and Treasury tender offers) are exempt. Similarly, banks are exempt if they deal with a registered broker-dealer under a "networking" arrangement, assuming they meet the following conditions: (1) the transacting broker must be clearly identified, (2) bank employees perform only clerical or administrative duties and do not receive transaction-based compensation, and (3) the registered broker-dealer receives and maintains all required information on each customer. Exempt networking arrangements must be fully disclosed to the customer. Finally, banks are exempt from registration requirements if their activities are limited to purchases and sales in a fiduciary capacity or purchases and sales of repurchase or reverse repurchase agreements.

The preceding exemptions provide relief from registration, but exempt banks must comply (if applicable) with regulations addressing custodial holdings for customers (17 CFR 450). Additionally, banks effecting repurchase/reverse repurchase agreements must comply with repurchase-transaction requirements detailed in 17 CFR 403.5(d).

## MUNICIPAL SECURITIES

Municipal securities are debt obligations issued by state and local governments and certain agencies and authorities. There are two broad categories of municipal bonds: general obligation bonds and revenue bonds. General obligation bonds (GOs) are backed by the full faith and credit and taxing authority of the government issuer. General obligation bonds are either limited or unlimited tax bonds. Limited tax bonds are issued by government entities whose taxing authority is limited to some extent by law or statute. For instance, a local government may face restrictions on the level of property taxes it can levy on property owners. State and local entities may also issue special tax bonds, which are supported by a specific tax. For instance, a highway project may be financed by a special gasoline tax levied to pay for the bonds. Unlimited tax bonds are issued by government



entities that are not restricted by law or statute in the amount of taxes they can levy; however, there may be some political limitations.

Municipal revenue bonds are backed by a specific project or government authority, and they are serviced by fees and revenues paid by users of the government entity. Revenue bonds are backed by public power authorities, non-profit hospitals, housing authorities, transportation authorities, and other public and quasi-public entities.

Effective March 13, 2000, well-capitalized state member banks were authorized by the Gramm-Leach-Bliley Act (GLB Act) to deal in, underwrite, purchase, and sell municipal revenue bonds without any limitations based on the bank's capital. (See 12 USC 24 (seventh).) Previously, banks were limited to only underwriting, dealing in, or investing in, without limitation, general obligation municipal bonds backed by the full faith and credit of an issuer with general powers of taxation. Member banks could invest in, but not underwrite or deal in, municipal revenue bonds, but the purchases and sales of such investment securities for any obligor were limited to 10 percent of a member bank's capital and surplus. As a result of the GLB Act amendment, municipal revenue bonds are the equivalent of type I securities for well-capitalized state member banks.<sup>2</sup> (See SR-01-13.) Banks that are not well capitalized may engage in more limited municipal securities activities relating to type II and type III securities. For example, banks may also deal in, underwrite, or invest in revenue bonds that are backed by housing, university, or dormitory projects.

In addition to municipal bonds, state and local governments issue obligations to meet short-term funding needs. These obligations are normally issued in anticipation of some specific revenue. The types of debt issued include tax-anticipation notes (TANs), revenue-anticipation notes (TRANs), grants-anticipation notes (GANs), bond-anticipation notes (BANs), commercial paper, and others.

Because of the large number and diverse funding needs of state and local governments (over 50,000 state and local governments have issued debt in the United States), there is a wide variety of municipal securities. Some municipal

security issues have complex structures that require an increased level of technical expertise to evaluate. As with all areas of banking, dealers who invest in complex instruments are expected to understand the characteristics of the instruments and how these instruments might affect their overall risk profile. While there are some large issuers, like the states of New York and California, most issuers are small government entities that place modest amounts of debt. Many of these issues are exempt from federal, state, and local income taxes; these exemptions, in part, determine the investor base for municipal bonds.

The customer base for tax-exempt municipal securities is investors who benefit from income that is exempt from federal income tax. This group includes institutional investors, such as insurance companies, mutual funds, and retail investors, especially individuals in high income-tax brackets.

## Credit Risk

Municipal securities activities involve differing degrees of credit risk depending on the financial capacity of the issuer. Larger issuers of municipal securities are rated by nationally recognized rating agencies (Moody's, S&P, etc.). Other municipalities achieve an investment-grade rating through the use of credit enhancements, usually in the form of a standby letter of credit issued by a financial institution. Banks are also involved in underwriting and placing nonrated municipal securities. Nonrated issues are typically small and are placed with a limited number of investors. Liquidity in the secondary market is limited, and bank dealers rarely carry nonrated issues in trading inventory.

Management should take steps to limit undue concentrations of credit risk arising from municipal-security underwriting and dealing. Exposure to nonrated issuers should be approved through the bank's credit-approval process with appropriate documentation to support the issuer's financial capacity. Activity in nonrated issues outside the bank's target or geographic market should also be avoided. In addition,

2. The Office of the Comptroller of the Currency published final amendments to its investment securities regulation (12 CFR 1) on July 2, 2001. (See 66 *Fed. Reg.* 34784.)

exposure should be aggregated on a consolidated basis, taking into account additional credit risk arising from traditional banking products (loans, letters of credit, etc.).

## Municipal Securities Rulemaking Board

The Securities Act Amendments of 1975 (15 USC 78o-4) extended a comprehensive network of federal regulation to the municipal securities markets. Pursuant to the act, municipal securities brokers and dealers are required to register with the SEC. The act also created a separate, self-regulatory body, the Municipal Securities Rulemaking Board (MSRB), to formulate working rules for the regulation of the municipal securities industry. The Federal Reserve is required to ensure compliance with those rules as they apply to state member banks.

A bank engaged in the business of buying and selling municipal securities must register with the SEC as a municipal securities dealer if it is involved in—

- underwriting or participating in a syndicate or joint account for the purpose of purchasing securities;
- maintaining a trading account or carrying dealer inventory; or
- advertising or listing itself as a dealer in trade publications, or otherwise holding itself out to other dealers or investors as a dealer.

Generally, a bank that buys and sells municipal securities for its investment portfolio or in a fiduciary capacity is not considered a dealer.

If a bank meets the SEC's criteria for registering as a municipal securities dealer, it must maintain a separately identifiable department or division involved in municipal securities dealing that is under the supervision of officers designated by the bank's board of directors. These designated officers are responsible for municipal securities dealer activities and should maintain separate records.

The Federal Reserve conducts a separate examination of the municipal securities dealer activities in banks that engage in such activities. This examination is designed to ensure compliance with the rules and standards formulated by the MSRB. For a complete description of the activities of a municipal securities dealer and

detailed procedures performed by the Federal Reserve examiners, see the *Municipal Securities Dealer Bank Examination Manual* issued by the Board of Governors of the Federal Reserve System.

## REPURCHASE AGREEMENTS AND SECURITIES LENDING

Repurchase agreements (repos) play an important role in the securities markets. A repo is the simultaneous agreement to sell a security and repurchase it at a later date. Reverse repos are the opposite side of the transaction, securities purchased with a later agreement to resell. From the dealer's perspective, a repo is a financing transaction (liability), and a reverse repo is a lending transaction (asset). Overnight repos are a one-day transaction; anything else is referred to as a "term repo." Approximately 80 percent of the repo market is overnight. Although any security can be used in a repurchase transaction, the overwhelming majority of transactions involve government securities.

Securities dealers use repos as an important source of liquidity. The majority of government securities trading inventory will typically be financed with repos. Reverse repos are used to obtain securities to meet delivery obligations arising from short positions or from the failure to receive the security from another dealer. Reverse repos also are an effective and low-risk means to invest excess cash on a short-term basis.

The repo rate is a money market rate that is lower than the federal funds rate due to the collateralized nature of the transaction. Opportunities also arise to obtain below-market-rate financing. This situation arises when demand exceeds supply for a specific bond issue and it goes on "special." Dealers who own the bond or control it under a reverse repo transaction can earn a premium by lending the security. This premium comes in the form of a below-market-rate financing cost on a repo transaction.

Many of the larger dealers also engage in proprietary trading of a matched book, which consists of a moderate to large volume of offsetting repos and reverse repos. The term "matched book" is misleading as the book is rarely perfectly matched. Although profit may be derived from the capture of a bid/ask spread on matched transactions, profit is more often

derived from maturity mismatches. In a falling-rate environment, traders lend long (reverse repos) and borrow short (repos). It is more difficult to profit in rising-rate environments because of the shape of the yield curve, which is usually upward-sloping. The overall size of the matched book and the length of the maturity mismatches will generally decline in a rising environment. Matched books are also used to create opportunities to control securities that may go on special, resulting in potential profit opportunities. Dealers engaging in matched-book trading provide important liquidity to the repo market.

Risk in a matched book should be minimized by establishing prudent limits on the overall size of the book, size of maturity mismatches, and restrictions on the maximum tenor of instruments. The overall risk of a matched book is usually small in relation to other trading portfolios. Maturity mismatches are generally short-term, usually 30 to 60 days, but may extend up to one year. Risk can be quickly neutralized by extending the maturity of assets or liabilities. Financial instruments (futures and forward rate agreements) can also be used to reduce risk.

Securities dealers may also engage in “dollar-roll” transactions involving mortgage-backed securities, which are treated as secured financings for accounting purposes. The “seller” of the security agrees to repurchase a “substantially identical” security from the “buyer,” rather than the same security. Many of the supervisory considerations noted above for repurchase agreements also apply to dollar-roll transactions. However, if the security to be repurchased is not substantially identical to the security sold, the transaction generally should be accounted for as a sale and not as a financing arrangement. The accounting guidance for “substantially identical” is described in American Institute of Certified Public Accountants (AICPA) Statement of Position 90-3, which generally requires debt instruments to have the same primary obligor or guarantor, the same form and type, the identical contractual interest rate, the same maturity or weighted average maturity, and other factors.

In addition, securities dealers may engage in securities lending or borrowing transactions. In substance, these transactions are very similar to repo transactions except the transactions have no stated maturity. The transactions are conducted through open-ended “loan” agreements that may be terminated on short notice by the lender or borrower. Although lending transac-

tions have historically been centered in corporate debt and equity obligations, the market increasingly involves loans of large blocks of U.S. government and federal-agency securities. To participate in this market, a bank may lend securities held in its investment account or trading account. Like repos, securities are lent to cover fails (securities sold but not available for delivery) and short sales. Collateral for the transactions can consist of other marketable securities or standby letters of credit; however, the large majority of transactions are secured by cash. Investors are willing to lend securities due to the additional investment income that can be earned by investing the cash collateral. When a securities loan is terminated, the securities are returned to the lender and the collateral to the borrower.

## Credit Risk

Since repurchase agreements and securities lending transactions are collateralized, credit risk is relatively minor if properly controlled. Some dealers have underestimated the credit risk associated with the performance of the counterparty and have not taken adequate steps to ensure their control of the securities serving as collateral. The market volatility of the securities held as collateral can also add to the potential credit risk associated with the transaction.

As an added measure of protection, dealers require customers to provide excess collateral. This excess is referred to as “margin.” The size of the margin will be a function of the volatility of the instrument serving as collateral and the length of the transaction. In addition to initial margin, term repos and security lending arrangements require additional margin if the value of the collateral declines below a specified level. Excess margin is usually returned to the counterparty if the value of the collateral increases. A daily “mark-to-market” or valuation procedure must be in place to ensure that calls for additional collateral are made on a timely basis. The valuation procedures should be independent of the trader and take into account the value of accrued interest on debt securities. It is important to point out that credit risk can arise from both asset transactions (reverse repos and securities borrowed) and liability transactions (repos and securities lent) because of market fluctua-



tions in collateral provided and received. Dealers should take steps to ensure that collateral provided is not excessive.

Policies and procedures should be in place to ensure transactions are conducted only with approved counterparties. Credit-limit approvals should be based on a credit analysis of the borrower. An initial review should be performed before establishing a relationship, with periodic reviews thereafter. Credit reviews should include an analysis of the borrower's financial statement, capital, management, earnings, business reputation, and any other relevant factors. Analyses should be performed in an independent department of the lender institution, by persons who routinely perform credit analyses. Analyses performed solely by the person managing the repo or securities lending programs are not sufficient. Credit and concentration limits should take into account other extensions of credit by other departments of the bank or affiliates. Procedures should be established to ensure that credit and concentration limits are not exceeded without proper authorization from management.

## Other Uses and Implications of Securities Lending

In addition to lending their own securities, financial institutions have become increasingly involved in lending customers' securities held in custody, safekeeping, trust, or pension accounts. These activities are typically organized within the bank's trust department. Not all institutions that lend securities or plan to do so have relevant experience. Because the securities available for lending often greatly exceed the demand, inexperienced lenders may be tempted to ignore commonly recognized safeguards. Bankruptcies of broker-dealers have heightened regulatory sensitivity to the potential for problems in this area.

Fees received on securities loans are divided between the custodial institution and the customer account that owns the securities. In situations involving cash collateral, part of the interest earned on the temporary investment of cash is returned to the borrower and the remainder is divided between the lender institution and the customer account that owns the securities.

In addition to a review of controls, examiners

should take steps to ensure that cash collateral is invested in appropriate instruments. Cash should be invested in high-quality, short-term money market instruments. Longer-term floating-rate instruments may also be appropriate; however, illiquid investments and products with customized features (for example, structured notes with imbedded options) should be avoided. Several banks have reported significant losses associated with inappropriate investments in securities lending areas.

## Securities-Lending Capacity

Securities lending may be done in various capacities and with differing associated liabilities. It is important that all parties involved understand in what capacity the lender institution is acting. The relevant capacities are described below.

### *Principal*

A lender institution offering securities from its own account is acting as principal. A lender institution offering customers' securities on an undisclosed basis is also considered to be acting as principal.

### *Agent*

A lender institution offering securities on behalf of a customer-owner is acting as an agent. To be considered a bona fide or "fully disclosed" agent, the lending institution must disclose the names of the borrowers to the customer-owners and the names of the customer-owners to the borrowers (or give notice that names are available upon request). In all cases, the agent's compensation for handling the transaction should be disclosed to the customer-owner. Undisclosed agency transactions, that is, "blind brokerage" transactions in which participants cannot determine the identity of the contra party, are treated as if the lender institution were the principal.

### *Directed Agent*

A lender institution that lends securities at the

direction of the customer-owner is acting as a directed agent. The customer directs the lender institution in all aspects of the transaction, including to whom the securities are loaned, the terms of the transaction (rebate rate and maturity/call provisions on the loan), acceptable collateral, investment of any cash collateral, and collateral delivery.

### *Fiduciary*

A lender institution that exercises discretion in offering securities on behalf of and for the benefit of customer-owners is acting as a fiduciary. For supervisory purposes, the underlying relationship may be as agent, trustee, or custodian.

### *Finder*

A finder brings together a borrower and a lender of securities for a fee. Finders do not take possession of the securities or collateral. Delivery of securities and collateral is directly between the borrower and the lender, and the finder does not become involved. The finder is simply a fully disclosed intermediary.

## MONEY MARKET INSTRUMENTS

In addition to bank-eligible securities activities, banks may engage in a substantial volume of trading in money market instruments. Federal funds, banker's acceptances, commercial paper, and certificates of deposit are forms of money market instruments. While these instruments may be used as part of the overall funding strategy, many firms actively engage in discretionary or proprietary trading in these instruments. As in matched-book repo activities, profits from trading money market instruments are derived from the bid/ask spread on matched transactions and the net interest spread from maturity mismatches.

This activity may result in overall money market arbitrage. Arbitrage is the coordinated purchase and sale of the same security or its equivalent, for which there is a relative price imbalance in the market. The objective of such activity is to obtain earnings by taking advantage of changing yield spreads. Arbitrage can

occur with items such as Eurodollar CDs, banker's acceptances, and federal funds, and with financial instruments such as futures and forwards.

Although the risk of money market trading is relatively straightforward, the potential risk can be significant based on the volume of trading and size of the mismatches. Despite the potential risk, these activities may offer attractive profit opportunities if effectively controlled. Short-term interest-rate markets are very liquid, and risk can be quickly neutralized by changing the maturity profile of either assets or liabilities. Financial instruments (such as futures and forward rate agreements) can also be an effective tool to manage risk. Money market trading may be managed as a separate product line or may be integrated with trading in other interest-rate products (such as swaps, caps, or floors). Examiners should take steps to ensure that appropriate limits are in place for money market trading, including restrictions on aggregate notional size, the size of maturity mismatches, and the maximum tenor of instruments.

## Federal Funds

Commercial banks actively use the federal funds market as a mechanism to manage fluctuations in the size and composition of their balance sheet. Federal funds are also an efficient means to manage reserve positions and invest excess cash on a short-term basis. Although transactions are generally unsecured, they can also be secured. The majority of transactions are conducted overnight; however, term transactions are also common. Federal funds trading will often involve term transactions in an attempt to generate positive net interest spread by varying the maturities of assets and liabilities.

Banks have traditionally engaged in federal funds transactions as principal, but an increasing number of banks are conducting business as agent. These agency-based federal funds transactions are not reported on the agent's balance sheet. Dealer banks may also provide federal funds clearing services to their correspondent banks.

## Banker's Acceptances

Banker's acceptances are time drafts drawn on

and accepted by a bank. They are the customary means of effecting payment for merchandise sold in import-export transactions, as well as a source of financing used extensively in international trade. Banker's acceptances are an obligation of the acceptor bank and an indirect obligation of the drawer. They are normally secured by rights to the goods being financed and are available in a wide variety of principal amounts. Maturities are generally less than nine months. Acceptances are priced like Treasury bills, with a discount figured for the actual number of days to maturity based on a 360-day year. The bank can market acceptances to the general public but must guarantee their performance.

## Commercial Paper

Commercial paper is a generic term that is used to describe short-term, unsecured promissory notes issued by well-recognized and generally sound corporations. The largest issuers of commercial paper are corporations, bank holding companies, and finance companies, which use the borrowings as a low-cost alternative to bank financing. Commercial paper is exempt from registration under the Securities Act of 1933 if it meets the following conditions:

- prime quality and negotiable
- not ordinarily purchased by the general public
- issued to facilitate current operational business requirements
- eligible for discounting by a Federal Reserve Bank
- maturity does not exceed nine months

Actively traded commercial paper is ordinarily issued in denominations of at least \$100,000 and often in excess of \$1 million. Commercial paper issuers usually maintain unused bank credit lines to serve as a source of back-up liquidity or contingency financing, principally in the form of standby letters of credit. Major commercial paper issuers are rated by nationally recognized rating agencies (Moody's, S&P, and others). Other issuers achieve higher ratings through the use of a credit enhancement, usually in the form of a standby letter of credit issued by a financial institution.

Based on Supreme Court rulings, commercial paper was considered a security for purposes of

the former Glass-Steagall Act. As a result, banks were generally prohibited from underwriting and dealing in commercial paper. Despite this restriction, banks participated in this market in an "agency capacity." When establishing a commercial paper dealership, many of the larger banks pursued business through an aggressive interpretation of an agency-transaction role. In practice, bank dealers engage in riskless-principal or best-efforts placement of commercial paper. Taking this logic a step further, others actively engage in competitive bidding and intraday distribution of newly issued paper. Because the paper settles on a same-day basis, the transactions are never part of the official end-of-day records of the bank. Although this technical point has been the subject of discussion, the practice has not been subject to regulatory challenge.

Commercial paper may be issued as an interest-bearing instrument or at a discount. Market trades are priced at a current yield, net of accrued interest due the seller or, if the commercial paper was issued at a discount, at a discount figured for the actual number of days to maturity based on a 360-day year.

The sale of commercial paper issued by bank affiliates must conform to legal restrictions and avoid conflicts of interest. Each certificate and confirmation should disclose the facts that the commercial paper is not a deposit and is not insured by the Federal Deposit Insurance Corporation.

## Certificates of Deposit

Negotiable certificates of deposit (CDs) issued by money-center banks are actively traded in denominations of \$100,000 to \$1 million. Interest generally is calculated on a 360-day year and paid at maturity. Secondary-market prices are computed based on current yield, net of accrued interest due the seller. Eurodollar CDs trade like domestic CDs except their yields are usually higher and their maturities are often longer.

## Credit-Risk and Funding Concentrations

In addition to market risk, money market policies and guidelines should recognize the credit risk

inherent in these products. Federal funds sold and deposit placements are essentially unsecured advances. To avoid undue concentrations of credit risk, activity with these products should be limited to approved counterparties. Limits should be established for each prospective counterparty. Tenor limits should also be considered to reduce the potential for credit deterioration over the life of the transaction. The size of limits should be based on both anticipated activity and the counterparty's financial capacity to perform. The credit analysis should be performed by qualified individuals in a credit department that is independent from the money market dealing function. In assessing the creditworthiness of other organizations, institutions should not rely solely on outside sources, such as standardized ratings provided by independent rating agencies, but should perform their own analysis of a counterparty's or issuer's financial strength. At a minimum, limits should be reassessed and credit analyses updated annually. Once established, limits should be monitored with exceptions documented and approved by the appropriate level of senior management. Exposure should also be aggregated on a consolidated basis with any other credit exposure arising from other product areas. Exposure to foreign bank counterparties should also be aggregated by country of domicile to avoid country-risk concentrations. The limit structure should be reviewed to ensure compliance with the requirements of Regulation F, Limitations on Interbank Liabilities, which places prudent limits on credit exposure to correspondent banks.

Maintaining a presence in the wholesale funding markets requires a strong reputation and increases potential liquidity risk. The prolonged use of a large volume of purchased funds to support a money market trading operation could also reduce the capacity to tap this market, if needed, for core funding. Guidelines should be in place to diversify sources of funding. Contingency plans should include strategies to exit or reduce the profile in these markets if the situation warrants.

## OPERATIONS AND INTERNAL CONTROLS

A bank dealer's operational functions should be designed to regulate the custody and movement of securities and to adequately account for

trading transactions. Because of the dollar volume and speed of trading activities, operational inefficiencies can quickly result in major problems.

### Sound Practices for Front- and Back-Office Operations

Bank dealer activities vary significantly among financial institutions, depending on the size and complexity of the trading products; trading, back-office, and management expertise; and the sophistication of systems. As a result, practices, policies, and procedures in place in one institution may not be necessary in another. The adequacy of internal controls requires sound judgment on the part of the examiner. The following is a list of policies and procedures that should be reviewed:

- Every organization should have comprehensive policies and procedures in place that describe the full range of bank dealer activities performed. These documents, typically organized into manuals, should at a minimum address front- and back-office operations; reconciliation guidelines and frequency; revaluation and accounting guidelines; descriptions of accounts; broker policies; a code of ethics; and the risk-measurement and -management methods, including a comprehensive limit structure.
- Every institution should have existing policies and procedures to ensure the segregation of duties among the trading, control, and payment functions.
- Revaluation sources should be independent from the traders for accounting purposes, risk oversight, and senior management reporting, although revaluation of positions may be conducted by traders to monitor positions.
- Trader and dealer telephone conversations should be taped to facilitate the resolution of disputes and to serve as a valuable source of information to auditors, managers, and examiners.
- Trade tickets and blotters (or their electronic equivalents) should be timely and complete to allow for easy reconciliation and for appropriate position and exposure monitoring. The volume and pace of trading may warrant virtually simultaneous creation of these records in some cases.

- Computer hardware and software applications must have the capacity to accommodate the current and projected level of trading activity. Appropriate disaster-recovery plans should be tested regularly.
- Every institution should have a methodology to identify and justify any off-market transactions. Ideally, off-market transactions would be forbidden.
- A clear institutional policy should exist for personal trading. If such trading is permitted at all, procedures should be established to avoid even the appearance of conflicts of interest.
- Every institution should ensure that the management of after-hours and off-premises trading, if permitted at all, is well documented so that transactions are not omitted from the automated blotter or the bank's records.
- Every institution should ensure that staff is both aware of and complies with internal policies governing the trader-broker relationship.
- Every institution that uses brokers should monitor the patterns of broker usage, be alert to possible undue concentrations of business, and review the list of approved brokers at least annually.
- Every institution that uses brokers should establish a policy that minimizes name substitutions of brokered transactions. All such transactions should be clearly designated as switches, and relevant credit authorities should be involved.
- Every institution that uses brokers for foreign-exchange transactions should establish a clear statement forbidding the lending or borrowing of brokers' points as a method to resolve discrepancies.
- Every organization should have explicit compensation policies to resolve disputed trades for all traded products. Under no circumstances should "soft-dollar" (the exchange of services in lieu of dollar compensation) or off-the-books compensation be permitted for dispute resolution.
- Every institution should have know-your-customer policies, and they should be understood and acknowledged by trading and sales staff.
- The designated compliance officer should perform a review of trading practices at least annually. In institutions with a high level of trading activity, interim reviews may be warranted.
- The organization should have an efficient confirmation-matching process that is fully independent from the dealing function. Documentation should be completed and exchanged as close to completion of a transaction as possible.
- Auditors should review trade integrity and monitoring on a schedule in accordance with its appropriate operational-risk designation.
- Organizations that have customers who trade on margin should establish procedures for collateral valuation and segregated custody accounts.

## Fails

In some cases, a bank may not receive or deliver a security by settlement date. "Fails" to deliver for an extended time or a substantial number of cancellations are sometimes characteristic of poor operational control or questionable trading activities.

Fails should be controlled by prompt reporting and follow-up procedures. The use of multi-copy confirmation forms enables operational personnel to retain and file a copy by settlement date and should allow for prompt fail reporting and resolution.

## Revaluation

The frequency of independent revaluation should be driven by the level of an institution's trading activity. Trading operations with high levels of activity may need to perform daily revaluation; however, it is important to note that independent revaluations are less critical when inventory is turning over quickly or end-of-day positions are small. In these situations, the majority of profit and loss is realized rather than unrealized. Only unrealized profit and loss on positions carried in inventory are affected by a revaluation. At a minimum, every institution should conduct an independent revaluation at the end of each standard accounting period (monthly or quarterly). There will be situations when certain securities will be difficult to price due to lack of liquidity or recent trading activity. If management relies on trader estimates in these situa-

tions, a reasonableness test should be performed by personnel who are independent from the trading function. A matrix-pricing approach may also be employed. This involves the use of prices on similar securities (coupon, credit quality, and tenor) to establish market prices.

## Control of Securities

Depository institutions need to adopt procedures to ensure that ownership of securities is adequately documented and controlled. While this documentation and control once involved taking physical possession of the securities either directly or through a third-party custodian, the securities markets are quickly moving to a book-entry system. In this context, safekeeping is more of a concept than a reality. As the markets change, documenting the chain of ownership becomes the primary mechanism to prevent losses arising from a counterparty default. This documentation involves the matching of incoming and outgoing confirmations and frequent reconciliations of all accounts holding securities (Federal Reserve, customer, custodian, and other dealers). When the dealer holds securities on behalf of its customers, similar safeguards also need to be in place. Although this documentation process can be burdensome, it is necessary to protect a dealer's interest in securities owned or controlled. Many active dealers have automated the reconciliation and matching process. This reduces the potential for human error and increases the likelihood that exceptions can be uncovered and resolved quickly.

Because of the relatively short periods of actual ownership associated with repurchase agreements, potential losses could be significant if prudent safeguards are not followed. Significant repo volume or matched-book trading activities only heighten this concern. To further protect their interests, dealers should enter into written agreements with each prospective repurchase-agreement counterparty. Although the industry is moving toward standardized master agreements, some degree of customization may occur. The agreements should be reviewed by legal counsel for their content and compliance with established minimum documentation standards. In general, these agreements should specify the terms of the transaction and the duties of both the buyer and seller. At a mini-

mum, provisions should cover the following issues:

- acceptable types and maturities of collateral securities
- initial acceptable margin for collateral securities of various types and maturities
- margin maintenance, call, default, and sellout provisions
- rights to interest and principal payments
- rights to substitute collateral
- individuals authorized to transact business on behalf of the depository institution and its counterparty

Written agreements should be in place before commencing activities.

## TRADING AND CAPITAL-MARKETS ACTIVITIES MANUAL

The *Trading and Capital-Markets Activities Manual*, developed by the Federal Reserve System, is a valuable tool to help examiners understand the complex and often interrelated risks arising from capital-markets activities. The products addressed in the previous subsections and their associated risks are covered in greater detail in the manual.

As noted in the preceding sections, and further addressed in the *Trading and Capital-Markets Activities Manual*, other trading instruments could be included in the bank dealer or money market trading operation. Financial instruments such as futures and forward rate agreements are often used to modify or hedge the risk associated with cash instruments (dealer inventory and money market positions). The bank dealer may also be involved in other instruments including asset-backed securities (mortgage-backed and consumer-receivable-backed). Other departments of the bank may also use securities products as part of an unrelated trading activity. For example, interest-rate-swap traders often use cash bonds to hedge or modify market-risk exposure. In this capacity, the swap desk would be a customer of the government securities dealer. These overlaps in product focus and usage make it critical for examiners to understand the organizational structure and business strategies before establishing examination scope.

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## OTHER ISSUES

### Intercompany Transactions

Examiners should review securities and repurchase-agreement transactions with affiliates to determine compliance with sections 23A and 23B of the Federal Reserve Act. Money market transactions may also be subject to limitations under section 23A; however, these restrictions generally do not apply to transactions between bank subsidiaries that are 80 percent or more commonly owned by a bank holding company. Intercompany transactions between securities underwriting affiliates and their bank affiliates should be carefully reviewed to ensure compliance with Board operating standards and sections 23A and 23B.

### Agency Relationships

Many dealer banks engage in securities transactions only in an agency capacity. Acting as an agent means meeting customers' investment needs without exposing the firm to the price risk associated with dealing as principal. Risk is relatively low as long as appropriate disclosures are made and the bank does not misrepresent the nature or risk of the security.

Agency-based federal funds transactions are also becoming more common. By serving only as an agent to facilitate the transaction, a bank can meet its correspondent's federal funds needs without inflating the balance sheet and using capital. Examiners should review agency-based

money market transactions to ensure that the transactions are structured in a manner that insulates the bank from potential recourse, either moral or contractual. If legal agreements are not structured properly, the courts could conclude that the agent bank was acting a principal. In this situation, the loss could be recognized by the agent bank, not its customer.

Although no single feature can determine whether an agency relationship really exists, the courts have recognized a variety of factors in distinguishing whether the persons to whom “goods” were transferred were buyers or merely agents of the transferor. Although some of these distinguishing factors may not apply to federal-funds transactions because they involve the transfer of funds rather than material goods, some parallels can be drawn. An agency relationship would appear to encompass, although not necessarily be limited to, the following elements:

- The agent bank must agree to act on behalf of the seller of the federal funds (“seller”) and not on its own behalf.
- The agent should fully disclose to all parties to the transaction that it is acting as agent on behalf of the seller and not on its own behalf.
- The seller, not the agent bank, must retain title to the federal funds before their sale to a purchasing institution.
- The seller, not the agent bank, must bear the risk of loss associated with the federal-funds sale.
- The agent bank’s authority in selling federal funds and accounting for these sales to the seller should be controlled by the seller or by some guidelines to which the seller has agreed. The agent bank should sell only to those banks stipulated on a list of banks approved, reviewed, and confirmed periodically by the seller bank.
- The agent bank should be able to identify the specific parties (sellers and purchasers) to a federal-funds sale and the amount of each transaction for which the agent has acted.
- The agent bank’s compensation should generally be based on a predetermined fee schedule or percentage rate (for example, a percentage based on the number or size of transactions). The agent should generally not receive compensation in the form of a spread over a predetermined rate that it pays to the seller. (If the agent bank’s compensation is in the form of a spread over the rate it pays to the seller,

this situation would appear to be more analogous to acting as a principal and suggests that the transactions should be reported on the “agent’s” balance sheet.)

By structuring agency agreements to include provisions that encompass these factors and by conducting agency activities accordingly, agent banks can lower the possibility that they would be considered a principal in the event of a failure of a financial institution that had purchased funds through the agent. Generally, as a matter of prudent practice, each bank acting as an agent should have written agreements with principals encompassing the above elements and have a written opinion from legal counsel as to the bona fide nature of the agency relationships.

Selling through an agent should not cause a bank to neglect a credit evaluation of the ultimate purchasers of these funds. Under the more traditional mode of conducting federal-funds transactions, banks sell their federal funds to other banks, which in many instances are larger regional correspondents. These correspondent banks in turn may resell the federal funds to other institutions. Since the correspondent is acting as a principal in these sales, the banks selling the funds to the correspondent are generally not concerned about the creditworthiness of those purchasing the federal funds from the correspondent/principal. Rather, the original selling banks need to focus solely on the creditworthiness of their correspondent banks, with which they should be quite familiar.

However, when conducting federal-funds sales through an agent, selling banks, in addition to considering the financial condition of their agent, should also subject the ultimate purchasing banks to the same type of credit analysis that would be considered reasonable and prudent if the seller banks were lending directly to the ultimate borrowers rather than through agents. Banks selling federal funds through agents should not relinquish their credit-evaluation responsibilities to their agent banks.

## REPORTING

Securities held for trading purposes and the income and expense that results from trading activities should be isolated by specific general ledger or journal accounts. The balances in those accounts should be included in the



appropriate reporting categories for regulatory reporting.

Instructions for the Consolidated Report of Condition and Income (call report) require that securities, derivative contracts, and other items held in trading accounts be reported consistently at market value, or at the lower of cost or market value, with unrealized gains and losses recognized in current income. For further detail, refer to the glossary section of the call report instructions under “trading account.” With either method, the carrying values of trading-security inventories should be evaluated periodically (monthly or quarterly), based on current market prices. The increase or decrease in unrealized appreciation or depreciation resulting from that revaluation should be credited or charged to income. Periodic independent revaluation is the most effective means of measuring the trading decisions of bank management.

For reporting purposes, the trading department’s income should include not only revaluation adjustments, but also profits and losses from the sale of securities, and other items related to the purchase and sale of trading securities. Interest income from trading assets, salaries, commissions, and other expenses should be excluded from trading income for reporting purposes; however, these items should be considered by management when evaluating the overall profitability of the business.

When the lender institution is acting as a fully disclosed agent, securities-lending activities need not be reported on the call report. However, lending institutions offering indemnification against loss to their customer-owners should report the associated contingent liability gross in Schedule RC-L as “other significant commitments and contingencies.”

## Recordkeeping and Confirmation Rules

Regulation H contains rules establishing uniform standards for bank recordkeeping, confirmation, and other procedures in executing securities transactions for bank customers. The regulation applies, in general, to those retail commercial activities where the bank effects securities transactions at the direction and for the account of customers. The purpose of the rules is to ensure that purchasers of securities are provided adequate information concerning a

transaction and that adequate records and controls are maintained for securities transactions. Under the rules, banks are required to maintain certain detailed records concerning securities transactions, to provide written confirmations to customers under certain circumstances, and to establish certain written policies and procedures. The requirements generally do not apply to banks that make 200 or fewer securities transactions a year for customers (exclusive of transactions in U.S. government and agency obligations) and to transactions subject to the requirements of the MSRB.

## Due Bills

A “due bill” is an obligation that results when a firm sells a security or money market instrument and receives payment, but does not deliver the item sold. Due bills issued should be considered as borrowings by the issuing firm, and alternatively, due bills received should be considered as lending transactions. Dealers should not issue due bills as a means of obtaining operating funds or when the underlying security can be delivered at settlement. Customers of the dealer enter transactions with an implicit understanding that securities transactions will be promptly executed and settled unless there is a clear understanding to the contrary. Consequently, dealers should promptly disclose the issuance of a due bill to a customer when funds are taken but securities or money market instruments are not delivered to the customer. Such disclosure should reference the applicable transaction; state the reason for the creation of a due bill; describe any collateral securing the due bill; and indicate that to the extent the market value of the collateral is insufficient, the customer may be an unsecured creditor of the dealer.

Due bills that are outstanding for more than three days and are unsecured could be construed as funding and should be reported as “liabilities for borrowed monies” on the call report. These balances are subject to reserve requirements imposed by Regulation D.

## ESTABLISHING SCOPE

Obtaining an overview of the organization, management structure, products offered, and control

environment is a critical step in the examination process. Based on this assessment, an examiner should determine the appropriate resources and skill level. In situations where an institution is active in either the government or municipal securities markets, it is essential to allocate additional resources for GSA and MSRB com-

pliance. The assigned examiners should be familiar with the provisions of GSA and MSRB as well as with the related examination procedures. For active proprietary trading units, it is important to assign examiners who have a reasonable working knowledge of the concepts outlined in the *Trading Activities Manual*.

# Bank Dealer Activities

## Examination Objectives

Effective date November 1995

## Section 2030.2

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1. To determine if the policies, practices, procedures, and internal controls regarding bank dealer activities are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the trading portfolio for credit quality and marketability.
4. To determine the scope and adequacy of the audit compliance functions.
5. To determine compliance with applicable laws and regulations.
6. To ensure investor protection.
7. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Bank Dealer Activities

## Examination Procedures

Effective date December 1985

## Section 2030.3

1. If selected for implementation, complete or update the Bank Dealer Activities section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if corrections have been accomplished.
4. Request that the bank provide the following schedules:
  - a. An aged schedule of securities that have been acquired as a result of underwriting activities.
  - b. An aged schedule of trading account securities and money market instruments held for trading or arbitrage purposes. Reflect commitments to purchase and sell securities and all joint account interests.
  - c. A schedule of short-sale transactions.
  - d. An aged schedule of due bills.
  - e. A list of bonds borrowed.
  - f. An aged schedule of "fails" to receive or deliver securities on unsettled contracts.
  - g. A schedule of approved securities borrowers and approved limits.
  - h. A schedule of loaned securities.
  - i. A schedule detailing account names and/or account numbers of the following customer accounts:
    - Own bank trust accounts.
    - Own bank permanent portfolio.
    - Affiliated banks' permanent portfolio accounts.
    - Personal accounts of employees of other banks.
    - Accounts of brokers or other dealers.
    - Personal accounts of employees of other brokers or dealers.
  - j. A list of all joint accounts entered into since the last examination.
  - k. A list of underwriting since the last examination and whether such securities were acquired by negotiation or competitive bid.
    1. A list of all financial advisory relationships.
5. Agree balances of appropriate schedules to general ledger and review reconciling items for reasonableness.
6. Determine the extent and effectiveness of trading policy supervision by:
  - a. Reviewing the abstracted minutes of meetings of the board of directors and/or of any appropriate committee.
  - b. Determining that proper authorization for the trading officer or committee has been made.
  - c. Ascertaining the limitations or restrictions on delegated authorities.
  - d. Evaluating the sufficiency of analytical data used in the most recent board or committee trading department review.
  - e. Reviewing the methods of reporting by department supervisors and internal auditors to ensure compliance with established policy and law.
  - f. Reaching a conclusion about the effectiveness of director supervision of the bank's trading policy. Prepare a memo for the examiner assigned "Duties and Responsibilities of Directors" stating your conclusions. All conclusions should be supported by factual documentation.

(Before continuing, refer to steps 14 and 15. They should be performed in conjunction with the remaining examination steps.)
7. Ascertain the general character of underwriting and direct placement activities and the effectiveness of department management by reviewing underwriter files and ledgers, committee reports and offering statements to determine:
  - a. The significance of underwriting activities and direct placements of type III securities as reflected by the volume of sales and profit or loss on operations. Compare current data to comparable prior periods.
  - b. Whether there is a recognizable pattern in:
    - The extent of analysis of material

- information relating to the ability of the issuer to service the obligation.
- Rated quality of offerings.
  - Point spread of profit margin for unrated issues.
  - Geographic distribution of issuers.
  - Syndicate participants.
  - Bank's trust department serving as corporate trustee, paying agent and transfer agent for issuers.
  - Trustee, paying agent and transfer agent business being placed with institutions that purchase a significant percentage of the underwriter or private placement offering.
- c. The volume of outstanding bids. Compare current data to comparable prior periods.
- d. The maturity, rated quality and geographic distribution of takedowns from syndicate participations.
- e. The extent of transfer to the bank's own or affiliated investment or trading portfolios or to trust accounts and any policies relating to this practice.
8. Determine the general character of trading account activities and whether the activities are in conformance with stated policy by reviewing departmental reports, budgets and position records for various categories of trading activity and determining:
- a. The significance of present sales volume compared to comparable prior periods and departmental budgets.
- b. Whether the bank's objectives are compatible with the volume of trading activity.
9. Review customer ledgers, securities position ledgers, transaction or purchase and sales journals and analyze the soundness of the bank's trading practices by:
- a. Reviewing a representative sample of agency and contemporaneous principal trades and determining the commission and price mark-up parameters for various sizes and types of transactions.
- b. Selecting principal transactions that have resulted in large profits and determining if the transaction involved:
- "Buy-backs" of previously traded securities.
  - Own bank or affiliated bank portfolios.
  - A security that has unusual quality and maturity characteristics.
- c. Reviewing significant inventory positions taken since the prior examination and determining if:
- The quality and maturity of the inventory position was compatible with prudent banking practices.
  - The size of the position was within prescribed limits and compatible with a sound trading strategy.
- d. Determining the bank's exposure on off-setting repurchase transactions by:
- Reviewing the maturities of offsetting re-po and reverse re-po agreements to ascertain the existence, duration, amounts and strategy used to manage unmatched maturity "gaps" and extended (over 30 days) maturities.
  - Reviewing records since the last examination to determine the aggregate amounts of:
    - Matched repurchase transactions.
    - Reverse re-po financing extended to one or related firms(s).
  - Performing credit analysis of significant concentrations with any single or related entity(ies).
  - Reporting the relationship of those concentrations to the examiners assigned "Concentration of Credits" and "Funds Management."
10. Determine the extent of risk inherent in trading account securities which have been in inventory in excess of 30 days and:
- a. Determine the dollar volume in extended holdings.
- b. Determine the amounts of identifiable positions with regard to issue, issuer, yield, credit rating, and maturity.
- c. Determine the current market value for individual issues which show an internal valuation mark-down of 10 percent or more.
- d. Perform credit analyses on the issuers of non-rated holdings identified as significant positions.
- e. Perform credit analyses on those issues with valuation write-downs considered significant relative to the scope of trading operations.
- f. Discuss plans for disposal of slow moving inventories with management and determine the reasonableness of those plans in light of current and projected market trends.
11. Using an appropriate technique, select issues

- from the schedule of trading account inventory. Test valuation procedures by:
- a. Reviewing operating procedures and supporting workpapers and determining if prescribed valuation procedures are being followed.
  - b. Comparing bank prepared market prices, as of the most recent valuation date, to an independent pricing source (use trade date “bid” prices).
  - c. Investigating any price differences noted.
12. Using an appropriate technique, select transactions from the schedule of short sales and determine:
- a. The degree of speculation reflected by basis point spreads.
  - b. Present exposure shown by computing the cost to cover short sales.
  - c. If transactions are reversed in a reasonable period of time.
  - d. If the bank makes significant use of due-bill transactions to obtain funds for its banking business:
    - Coordinate with the examiner assigned “Review of Regulatory Reports” to determine if the bank’s reports of condition reflect due bill transactions as “liabilities for borrowed money.”
    - Report amounts, duration, seasonal patterns and budgeted projections for due bills to the examiner assigned “Funds Management.”
13. If the bank is involved in agency-based federal funds activity:
- a. At the beginning or in advance of each examination of a banking organization which has been acting as an agent in the purchase and sale of federal funds for other institutions, examiners should obtain certain information which will help them determine the nature and extent of this activity. The information should include:
    - A brief description of the various types of agency relationships (i.e., involving federal funds or other money market activities) and the related transactions.
    - For each type of agency relationship, copies of associated forms, agency agreements, documents, reports and legal opinions. In addition, if the banking organization has documented its analysis of the risks associated with the activity, a copy of the analysis should be requested by the examiner.
  - b. For each type of agency relationship, a summary of the extent of the activity including:
    - The number of institutions serviced as principals.
    - The size range of the institutions (i.e., institutions serviced have total assets ranging from \$\_\_\_\_\_ to \$\_\_\_\_\_).
    - General location of sellers and purchasers serviced under agency relationships (i.e., New York State, Midwest, etc.)
    - Estimate of average daily volume of federal funds or money market instruments purchased and sold under agency relationships and the high and low volume over the period since the last examination inquiry (or since activity was begun, if more recent).
    - Names of individuals in the bank that are responsible for these agency relationships.
  - c. A historical file of this information should be maintained in order to determine the nature, extent and growth of these activities over time.
  - b. Once the examination work in this area has been started, the examiner should attempt to discern any situation, activity or deficiency in this area that might suggest that an agency relationship does *not* actually exist. A negative response to the following examination guidelines section dealing with agency agreements may signal such a deficiency. In addition, any other money market agency relationships that involve new or unusual financial transactions should be evaluated to determine the nature of the risks involved and compliance, to the extent applicable, with the guidelines.
  - c. The examiner should determine that the banking organization’s written policies, procedures, and other documentation associated with this activity are consistent with the Federal Reserve System’s Examination Guidelines. If the bank does not have written policies the examiner should strongly advise that they be developed due to the complex nature of this activity and the potential risks associated with it.
  - d. After reviewing the policies, procedures,

and appropriate documentation, the examiner should be able to respond positively to the following questions:

- Banking organizations acting as *agents in the sale of federal funds*<sup>1</sup>

- Has this form of activity been approved by the board of directors?
- Are the bank's individual agency arrangements and transactions:
  - supported by written agency agreements, and
  - reviewed and approved by appropriate officers?
- Do the written agency agreements that support this activity include provisions indicating that (a negative answer may indicate that the bank is not in fact an agent):
  - the agent bank will be acting *on behalf of the original or principal seller of federal funds ("seller")* in conducting these activities and not on the agent bank's own behalf?
  - the agency relationship will be fully disclosed to all banks involved in the transactions?
  - the seller, and not the agent bank, must retain legal title to the federal funds before they are sold to a third party bank?
  - the seller, and not the agent bank, bears the risk of loss?
  - the agent bank's authority in selling federal funds and in accounting for this activity to the seller should be controlled by the seller or by standards to which it has agreed? To implement this, does the agreement or its attachments include the following seller-approved items:
    1. lists of banks to whom the agent may sell federal funds,<sup>2</sup> and

2. limits on the amounts that can be sold to these banks?

- Does the agent have a written opinion from its legal counsel as to the bona fide nature of the agency relationship?
- Does the accounting and reporting system of the agent bank *enable* it to account for the federal funds transactions on a period basis (i.e., at least weekly) to the sellers? (Although more frequent accounting may not be required by the sellers, the agent on any day should have the capacity to identify for the seller the banks to whom the seller's funds have been sold.)
- Does the agent's accounting system identify *each bank* which has purchased federal funds from a particular seller bank and include (at least) the following information for *each bank* in which the funds are being invested?<sup>3</sup>
  - information to clearly identify the name and location of the bank (or other entity)
  - amount of federal funds sold and amount of interest earned
  - terms of transaction, and maturity date
  - lending limits agreed to
- Does the agent bank actually disclose to banks or other organizations that are part of these agency-based transactions that it is acting as agent?
- Is the agent bank's compensation in the form of a predetermined fee schedule or percentage rate based, for example, on the size of transactions, as opposed to compensation in the form of a spread over the rate that it pays to the seller bank? (If the agent bank's compensation is in the form of a spread over the rate it pays to the selling bank, this situation would appear to be more akin to acting as an intermediary and suggests that the

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1. Although it is conceivable that a purchaser could engage an agent to *obtain* federal funds on its behalf, these guidelines focus primarily on situations where the seller has engaged an agent to sell federal funds on its behalf because the associated risks of such transactions are borne by the sellers and their agents.

2. Seller banks could conceivably design their lists of approved banks to encompass a large number of financially sound institutions and still be considered to be fulfilling this supervisory requirement.

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3. The entities referred to as "ultimate purchasers" or "ultimate borrowers" are those that have the *responsibility to repay* the original seller bank, and not any intervening agents that may pass on the federal funds to these purchasers.

- transactions should be reported on its balance sheet.)
- Banking organizations that are involved in agency-based federal funds relationships as *sellers*
    - Does the bank support its transactions with written agency agreements?
    - Does the seller bank evaluate the credit worthiness of the ultimate borrowers of federal funds and establish limits for each and are these limits periodically reviewed at least every six months?<sup>3,4</sup>
    - Does the bank periodically (i.e., at least weekly) receive an accounting from the agent which includes the following information for *each bank* to whom the seller bank's federal funds were sold?
      - information to identify name and location of bank
      - amount of federal funds sold and interest earned
      - federal funds sales limits agreed to (if the seller bank is a principal)
    - Is the bank's management and board of directors aware of and have they approved the agency relationship?
  - Do internal and/or external auditors periodically review the policies, procedures, and internal controls associated with this activity and the activity's impact on the earnings and financial condition of the banking organization? Is their evaluation reported to management? (Applies to banks acting as *agents* in the sale of federal funds, and those banks involved as *sellers* of federal funds.)
  - In addition to the items considered above, the examiner should determine what the impact of these transactions has been on the bank's earnings and financial condition. If the impact has been negative, or if the answer to any of the above questions is negative, the
- examiner should discuss these matters with bank management and seek remedial action.
14. Analyze the effectiveness of operational controls by reviewing recent cancellations and fail items that are a week or more beyond settlement date and determine:
    - a. The amount of extended fails.
    - b. The planned disposition of extended fails.
    - c. If the control system allows a timely, productive follow-up on unresolved fails.
    - d. The reasons for cancellations.
    - e. The planned disposition of securities that have been inventoried prior to the recognition of a fail or a cancellation.
  15. Determine compliance with applicable laws, rulings, and regulations by performing the following for:
    - a. *12 CFR 1.3—Eligible Securities:*
      - Review inventory schedules of underwriting and trading accounts and determine if issues whose par value is in excess of 10 percent of the bank's capital and unimpaired surplus are type I securities.
      - Determine that the total par value of type II investments does not exceed 10 percent of the bank's capital and unimpaired surplus, based on the combination of holdings and permanent portfolio positions in the same securities.
      - Elicit management's comments and review underwriting records on direct placement of type III securities, and determine if the bank is dealing in type III securities for its own account by ascertaining if direct placement issues have been placed in own bank or affiliated investment portfolios or if underwriting proceeds were used to reduce affiliate loans.
    - b. *Section 23A of the Federal Reserve Act (12 USC 371(c) and 375)—Preferential Treatment:* Obtain a list of domestic affiliate relationships and a list of directors and principal officers and their business interests from appropriate examiners and determine whether transactions, include securities clearance services, involving affiliates, insiders or their interests are on terms less favorable to the bank than those transactions involving unrelated parties.
    - c. *Regulation D (12 CFR 204.2)—Due Bills:*

4. This requirement is intended to mean that seller banks should conduct the type of credit analysis that would be considered reasonable and prudent for a direct federal funds activity (i.e., those federal funds activities not conducted through agents).



- Review outstanding due bills and determine if:
    - The customer was informed that a due bill would be issued instead of the purchased security.
    - Safekeeping receipts are sent to safekeeping customers only after the purchased security has been delivered.
  - Review due bills outstanding over three business days and determine if they are collateralized or properly reserved.
  - Review collateralized due bills and determine if the liability is secured by securities of the same type and of comparable maturity and with a market value at least equal to that of the security that is the subject of the due bill.
- d. *Regulation H (12 CFR 208.8(k))—Recordkeeping and Confirmation Requirements:* If the bank effects securities transactions at the direction and for the account of customers, determine if it is in compliance with this regulation by substantiating Internal Control questions 24–35.
16. Test for unsafe and unsound practices and possible violations of the Securities Exchange Act of 1934 by:
- a. Reviewing customer account schedules of own bank and affiliated bank permanent portfolios, trusts, other broker-dealers, employees of own or other banks and other broker-dealers. Use an appropriate technique to select transactions and compare trade prices to independently established market prices as of the date of trade.
  - b. Reviewing transactions, including U.S. government tender offer subscription files, involving employees and directors of own or other banks and determine if the funds used in the transactions were misused bank funds or the proceeds of reciprocal or preferential loans.
  - c. Reviewing sales to affiliated companies to determine that the sold securities were not subsequently repurchased at an additional mark-up and that gains were not recognized a second time.
  - d. Reviewing commercial paper sales journals or confirmations to determine if the bank sells affiliate commercial paper. If so, determine if:
    - The bank sells affiliate-issued commercial paper to institutions and financially sophisticated individuals only.
    - Sales are generally denominated in amounts of \$25,000 or more.
    - Each sale confirmation discloses that the affiliate-issued commercial paper is not an insured bank deposit.
- e. Reviewing securities position records and customer ledgers with respect to large volume repetitive purchase and sales transactions and:
- Independently testing market prices of significant transactions which involve the purchase and resale of the same security to the same or related parties.
  - Investigating the purchase of large blocks of securities from dealer firms just prior to month end and their subsequent resale to the same firm just after the beginning of the next month.
- f. Reviewing lists of approved dealer firms and determining that the approval of any firm that handles a significant volume of agency transactions is based on competitive factors rather than deposit relationships.
- g. Reviewing customer complaint files and determining the reasons for such complaints.
17. Discuss with an appropriate officer and prepare report comments concerning:
- a. The soundness of trading objectives, policies and practices.
  - b. The degree of legal and market risk assumed by trading operations.
  - c. The effectiveness of analytical, reporting and control systems.
  - d. Violations of law.
  - e. Internal control deficiencies.
  - f. Apparent or potential conflicts of interest.
  - g. Other matters of significance.
18. Reach a conclusion regarding the quality of department management and state your conclusions on the management brief provided by the examiner assigned “Management Assessment.”
19. Update workpapers with any information that will facilitate future examinations.

# Bank Dealer Activities

## Internal Control Questionnaire

Effective date December 1985

## Section 2030.4

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

This section applies to all bank dealer activities except those involving municipal securities, which are reviewed as part of a separate and distinct Municipal Bond Dealer Examination.

### SECURITIES UNDERWRITING TRADING POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written securities underwriting/trading policies that:
  - a. Outline objectives?
  - b. Establish limits and/or guidelines for:
    - Price mark-ups?
    - Quality of issues?
    - Maturity of issues?
    - Inventory positions (including when issued (WI) positions)?
    - Amounts of unrealized loss on inventory positions?
    - Length of time an issue will be carried in inventory?
    - Amounts of individual trades or underwriter interests?
    - Acceptability of brokers and syndicate partners?
  - c. Recognize possible conflicts of interest and establish appropriate procedures regarding:
    - Deposit and service relationships with municipalities whose issues have underwriting links to the trading department?
    - Deposit relationships with securities firms handling significant volumes of agency transactions or syndicate participations?
    - Transfers made between trading account inventory and investment portfolio(s)?
- The bank's trust department acting as trustee, paying agent, and transfer agent for issues which have an underwriting relationship with the trading department?
- d. State procedures for periodic, monthly or quarterly, valuation of trading inventories to market value or to the lower of cost or market price?
- e. State procedures for periodic independent verification of valuations of the trading inventories?
- f. Outline methods of internal review and reporting by department supervisors and internal auditors to insure compliance with established policy?
- g. Identify permissible types of securities?
- h. Ensure compliance with the rules of fair practice that:
  - Prohibit any deceptive, dishonest or unfair practice?
  - Adopt formal suitability checklists?
  - Monitor gifts and gratuities?
  - Prohibit materially false or misleading advertisements?
  - Adopt a system to determine the existence of possible control relationships?
  - Prohibit the use of confidential, non-public information without written approval of the affected parties?
  - Prohibit improper use of funds held on another's behalf?
  - Allocate responsibility for transactions with own employees and employees of other dealers?
  - Require disclosure on all new issues?
- i. Provide for exceptions to standard policy?
2. Are the underwriting/trading policies reviewed at least quarterly by the board to determine their adequacy in light of changing conditions?
3. Is there a periodic review by the board to assure that the underwriting/trading department is in compliance with its policies?

## OFFSETTING RESALE AND REPURCHASE TRANSACTIONS

4. Has the board of directors, consistent with its duties and responsibilities, adopted written offsetting repurchase transaction policies that:
  - a. Limit the aggregate amount of offsetting repurchase transactions?
  - b. Limit the amounts in unmatched or extended (over 30 days) maturity transactions?
  - c. Determine maximum time gaps for unmatched maturity transactions?
  - d. Determine minimally acceptable interest rate spreads for various maturity transactions.
  - e. Determine the maximum amount of funds to be extended to any single or related firms through reverse re-po transactions, involving unsold (through forward sales) securities?
  - f. Require firms involved in reverse re-po transactions to submit corporate resolutions stating the names and limits of individuals, who are authorized to commit the firm?
  - g. Require submission of current financial information by firms involved in reverse re-po transactions?
  - h. Provide for periodic credit reviews and approvals for firms involved in reverse re-po transactions?
  - i. Specify types of acceptable offsetting repurchase transaction collateral (if so, indicate type \_\_\_\_\_).
5. Are written collateral control procedures designed so that:
  - a. Collateral assignment forms are used?
  - b. Collateral assignments of registered securities are accompanied by powers of attorney signed by the registered owner?
    - Registered securities are registered in bank or bank's nominee name when they are assigned as collateral for extended maturity (over 30 days) reverse re-po transactions?
  - c. Funds are not disbursed until reverse re-po collateral is delivered into the physical custody of the bank or an independent safekeeping agent?
  - d. Funds are only advanced against pre-

determined collateral margins or discounts?

- If so, indicate margin or discount percentage \_\_\_\_\_.
- e. Collateral margins or discounts are predicated upon:
    - The type of security pledged as collateral?
    - Maturity of collateral?
    - Historic and anticipated price volatility of the collateral?
    - Maturity of the reverse re-po agreements?
  - f. Maintenance agreements are required to support predetermined collateral margin or discount?
  - g. Maintenance agreements are structured to allow margin calls in the event of collateral price declines?
  - h. Collateral market value is frequently checked to determine compliance with margin and maintenance requirements (if so, indicate frequency \_\_\_\_\_)?

## CUSTODY AND MOVEMENT OF SECURITIES

- \*6. Are the bank's procedures such that persons do not have sole custody of securities in that:
  - a. They do not have sole physical access to securities?
  - b. They do not prepare disposal documents that are not also approved by authorized persons?
  - c. For the security custodian, supporting disposal documents are examined or adequately tested by a second custodian?
  - d. No person authorizes more than one of the following transactions: execution of trades, receipt and delivery of securities, and collection or disbursement of payment?
7. Are securities physically safeguarded to prevent loss, unauthorized disposal or use? And:
  - a. Are negotiable securities kept under dual control?
  - b. Are securities counted frequently, on a surprise basis, reconciled to the securities record, and the results of such counts reported to management?

- c. Does the bank periodically test for compliance with provisions of its insurance policies regarding custody of securities?
- d. For securities in the custody of others:
- Are custody statements agreed periodically to position ledgers and any differences followed up to a conclusion?
  - Are statements received from brokers and other dealers reconciled promptly, and any differences followed up to a conclusion?
  - Are positions for which no statements are received confirmed periodically, and stale items followed up to a conclusion?
8. Are trading account securities segregated from other bank owned securities or securities held in safekeeping for customers?
- \*9. Is access to the trading securities vault restricted to authorized employees?
10. Do withdrawal authorizations require countersignature to indicate security count verifications?
11. Is registered mail used for mailing securities, and are adequate receipt files maintained for such mailings (if registered mail is used for some but not all mailings, indicate criteria and reasons)?
12. Are prenumbered forms used to control securities trades, movements and payments?
13. If so, is numerical control of prenumbered forms accounted for periodically by persons independent of those activities?
14. Do alterations to forms governing the trade, movement, and payment of securities require:
- \*a. Signature of the authorizing party?
  - b. Use of a change of instruction form?
15. With respect to negotiability of registered securities:
- a. Are securities kept in non-negotiable form whenever possible?
  - b. Are all securities received, and not immediately delivered, transferred to the name of the bank or its nominee and kept in non-negotiable form whenever possible?
  - c. Are securities received checked for negotiability (endorsements, signature, guarantee, legal opinion, etc.) and for completeness (coupons, warrants, etc.) before they are placed in the vault?

## RECORDS MAINTENANCE

16. Does the bank maintain:
- a. Order tickets which include:
    - Capacity as principal or agent?
    - If order is firm or conditional?
    - Terms, conditions or instructions and modifications?
    - Type of transaction (purchase or sale)?
    - Execution price?
    - Description of security?
    - Date and time of order receipt?
    - Date and time of execution?
    - Dealer's or customer's name?
    - Delivery and payment instructions?
    - Terms, conditions, date and time of cancellation of an agency order?
  - b. Customer confirmations:
    - Bank dealer's name, address and phone number?
    - Customer's name?
    - Designation of whether transaction was a purchase from or sale to the customer?
    - Par value of securities?
    - Description of securities, including at a minimum:
      - Name of issuer?
      - Interest rate?
      - Maturity date?
      - Designation, if securities are subject to limited tax?
      - Subject to redemption prior to maturity (callable)?
      - Designation, if revenue bonds and the type of revenue?
      - The name of any company or person in addition to the issuer who is obligated, directly or indirectly, to pay debt service on revenue bonds? (In the case of more than one such obligor, the phrase "multiple obligors" will suffice.)
      - Dated date, if it affects price or interest calculations?
      - First interest payment date, if other than semi-annual?
      - Designation, if securities are "fully registered" or "registered as principal"?
      - Designation, if securities are "pre-refunded"?

- Designation, if securities have been “called,” maturity date fixed by call notice and amount of call price?
  - Denominations of bearer bonds, if other than denominations of \$1,000 and \$5,000 par value?
  - Denominations of registered bonds, if other than multiples of \$1,000 par value up to \$100,000 par value?
  - Denominations of municipal notes?
  - Trade date and time of execution, or a statement that time of execution will be furnished upon written request of the customer?
  - Settlement date?
  - Yield and dollar price? Only the dollar price need to be shown for securities traded at par.
    - For transactions in callable securities effected on a yield basis, the resulting price calculated to the lowest of price to call premium, par option (callable at par) or to maturity, and if priced to premium call or par option, a statement to that effect and the call or option date and price used in the calculation?
  - Amount of accrued interest?
  - Extended principal amount?
  - Total dollar amount of transaction?
  - The capacity in which the bank dealer effected the transaction:
    - As principal for own account?
    - As agent for customer?
    - As agent for a person other than the customer?
    - As agent for both the customer and another person (dual agent)?
  - If a transaction is effected as agent for the customer or as dual agent:
    - Either the name of the contra-party or a statement that the information will be furnished upon request?
    - The source and amount of any commission or other remuneration to the bank dealer?
  - Payment and delivery instructions?
  - Special instructions, such as:
    - “Ex-legal” (traded without legal opinion)?
    - “Flat” (traded without interest)?
    - “In default” as to principal or interest?
- c. Dealer confirmations:
- Bank dealer’s name, address and telephone number?
  - Contra-party identification?
  - Designation of purchase from or sale to?
  - Par value of securities?
  - Description of securities, including at a minimum:
    - Name of issuer?
    - Interest rate?
    - Maturity date?
    - Designation, if securities are limited tax?
    - Subject to redemption prior to maturity (callable)?
    - Designation, if revenue bonds and the type of revenue?
    - Dated date, if it affects price or interest calculations?
    - First interest payment date, if other than semi-annual?
    - Designation, if securities are “fully registered” or “registered as principal”?
    - Designation, if securities are “pre-refunded”?
    - Designation, if securities have been “called,” maturity date fixed by call notice and amount of call price?
    - Denominations of bearer bonds, if other than denominations of \$1,000 and \$5,000 par value?
    - Denominations of registered bonds, if other than multiples of \$1,000 par value up to \$100,000 par value?
  - CUSIP number, if assigned (effective January 1, 1979)?
  - Trade date?
  - Settlement date?
  - Yield to maturity and resulting dollar price? Only the dollar price need be shown for securities traded at par or on a dollar basis.
    - For transactions in callable securities effected on a yield basis, the resulting price calculated to the lowest of price to call premium, par option (callable at par) or to maturity?

- If applicable, the fact that securities are priced to premium call or par option and the call or option date and price used in the calculation?
- Amount of accrued interest?
- Extended principal amount?
- Total dollar amount of transaction?
- Payment and delivery instructions?
- Special instructions, such as:
  - “Ex-legal” (traded without legal opinion)?
  - “Flat” (traded without interest)?
  - “In default” as to principal or interest?
- d. Purchase and sale journals or blotters which include:
  - Trade date?
  - Description of securities?
  - Aggregate par value?
  - Unit dollar price or yield?
  - Aggregate trade price?
  - Accrued interest?
  - Name of buyer or seller?
  - Name of party received from or delivered to?
  - Bond or note numbers?
  - Indication if securities are in registered form?
  - Receipts or disbursements of cash?
  - Specific designation of “when issued” transactions?
  - Transaction or confirmation numbers recorded in consecutive sequence to insure that transactions are not omitted?
  - Other references to documents of original entry?
- e. Short sale ledgers which include:
  - Sale price?
  - Settlement date?
  - Present market value?
  - Basis point spread?
  - Description of collateral?
  - Cost of collateral or cost to acquire collateral?
  - Carrying charges?
- f. Security position ledgers, showing separately for each security positioned for the bank’s own account:
  - Description of the security?
  - Posting date (either trade or settlement date, provided posting date is consistent with other records of original entry)?
  - Aggregate par value?
  - Cost?
  - Average cost?
  - Location?
  - Count differences classified by the date on which they were discovered?
- g. Securities transfer or validation ledgers which include:
  - Address where securities were sent?
  - Date sent?
  - Description of security?
  - Aggregate par value?
  - If registered securities:
    - Present name of record?
    - New name to be registered?
  - Old certificate or note numbers?
  - New certificate or note numbers?
  - Date returned?
- h. Securities received and delivered journals or tickets which include:
  - Date of receipt or delivery?
  - Name of sender and receiver?
  - Description of security?
  - Aggregate par value?
  - Trade and settlement dates?
  - Certificate numbers?
- i. Cash or wire transfer receipt and disbursement tickets which include:
  - Draft or check numbers?
  - Customer accounts debited or credited?
  - Notation of the original entry item that initiated the transaction?
- j. Cash or wire transfer journals which additionally include:
  - Draft or check reconcilements?
  - Daily totals of cash debits and credits?
  - Daily proofs?
- k. Fail ledgers which include:
  - Description of security?
  - Aggregate par value?
  - Price?
  - Fail date?
  - Date included on fail ledger?
  - Customer or dealer name?
  - Resolution date?
  - A distinction between a customer and a dealer fail?
  - Follow-up detail regarding efforts to resolve the fail?
- l. Securities borrowed and loaned ledgers which include:
  - Date of transaction?
  - Description of securities?

- Aggregate par value?
  - Market value of securities?
  - Contra-party name?
  - Value at which security was loaned?
  - Date returned?
  - Description of collateral?
  - Aggregate par value of collateral?
  - Market value of collateral?
  - Collateral safekeeping location?
  - Dates of periodic valuations?
- m. Records concerning written or oral put options, guarantee and repurchase agreements which include:
- Description of the securities?
  - Aggregate par value?
  - Terms and conditions of the option, agreement or guarantee?
- n. Customer account information which includes:
- Customer's name and residence or principal business address?
  - Whether customer is of legal age?
  - Occupation?
  - Name and address of employer? And:
    - Whether customer is employed by a securities broker or dealer or by a municipal securities dealer?
  - Name and address of beneficial owner or owners of the account if other than customer? And:
    - Whether transactions are confirmed with such owner or owners?
  - Name and address of person(s) authorized to transact business for a corporate, partnership or trustee account? And:
    - Copy of powers of attorney, resolutions or other evidence of authority to effect transactions for such an account?
  - With respect to borrowing or pledging securities held for the accounts of customers:
    - Written authorization from the customer authorizing such activities?
  - Customer complaints including:
    - Records of all written customer complaints?
    - Record of actions taken concerning those complaints?
- o. Customer and the bank dealer's own account ledgers which include:
- All purchases and sales of securities?
  - All receipts and deliveries of securities?
  - All receipts and disbursements of cash?
  - All other charges or credits?
- p. Records of syndicates' joint accounts or similar accounts formed for the purchase of municipal securities which include:
- Underwriter agreements? And:
    - Description of the security?
    - Aggregate par value of the issue?
  - Syndicate or selling group agreements? And:
    - Participants' names and percentages of interest?
    - Terms and conditions governing the formation and operation of the syndicate?
    - Date of closing of the syndicate account?
    - Reconciliation of syndicate profits and expenses?
  - Additional requirements for syndicate or underwriting managers which include:
    - All orders received for the purchase of securities from the syndicate or account, except bids at other than the syndicate price?
    - All allotments of securities and the price at which sold?
    - Date of settlement with the issuer?
    - Date and amount of any good faith deposit made with the issuer?
- q. Files which include:
- Advertising and sales literature
  - Prospectus delivery information?
- r. Internal supervisory records which include:
- Account reconciliation and follow-up?
  - Profit analysis by trader?
  - Sales production reports?
  - Periodic open position reports computed on a trade date or when issued basis?
  - Reports of own bank credit extensions used to finance the sale of trading account securities?

## PURCHASE AND SALES TRANSACTIONS

17. Are all transactions promptly confirmed in writing to the actual customers or dealers?
18. Are confirmations compared or adequately tested to purchase and sales memoranda and reports of execution of orders, and any differences investigated and corrected (including approval by a designated responsible employee)?
  - a. Are confirmations and purchase and sale memoranda checked or adequately tested for computation and terms by a second individual?
19. Are comparisons received from other dealers or brokers compared with confirmations, and any differences promptly investigated?
  - a. Are comparisons approved by a designated individual (if so, give name \_\_\_\_\_)?

## CUSTOMER AND DEALER ACCOUNTS

20. Do account bookkeepers periodically transfer to different account sections or otherwise rotate posting assignments?
21. Are letters mailed to customers requesting confirmation of changes of address?
22. Are separate customer account ledgers maintained for:
  - Employees?
  - Affiliates?
  - Own bank's trust accounts?
23. Are customer inquiries and complaints handled exclusively by designated individuals who have no incompatible duties?

## RECORDKEEPING AND CONFIRMATION REQUIREMENTS FOR CUSTOMER SECURITIES TRANSACTIONS (REGULATION H)

24. Are chronological records of original entry containing an itemized daily record of all purchases and sales of securities maintained?
25. Do the original entry records reflect:

- a. The account or customer for which each such transaction was effected?
- b. The description of the securities?
- c. The unit and aggregate purchase or sale price (if any)?
- d. The trade date?
- e. The name or other designation of the broker-dealer or other person from whom purchased or to whom sold?

If the bank has had an average of 200 or more securities transactions per year for customers over the prior three-calendar-year period, exclusive of transactions in U.S. government and federal agency obligations, answer questions 26, 27 and 28.

26. Does the bank maintain account records for each customer which reflect:
  - a. All purchases and sales of securities?
  - b. All receipts and deliveries of securities?
  - c. All receipts and disbursements of cash for transactions in securities for such account?
  - d. All other debits and credits pertaining to transactions in securities?
27. Does the bank maintain a separate memorandum (order ticket) of each order to purchase or sell securities (whether executed or cancelled) which includes:
  - a. The account(s) for which the transaction was effected?
  - b. Whether the transaction was a market order, limit order, or subject to special instructions?
  - c. The time the order was received by the trader or other bank employee responsible for affecting the transaction?
  - d. The time the order was placed with the broker-dealer, or if there was no broker-dealer, the time the order was executed or cancelled?
  - e. The price at which the order was executed?
  - f. The broker-dealer used?
28. Does the bank maintain a record of all broker-dealers selected by the bank to effect securities transactions and the amount of commissions paid or allocated to each such broker during the calendar year?
29. Does the bank, subsequent to effecting a securities transaction for a customer, mail or otherwise furnish to such customer either a copy of the confirmation of a broker-dealer relating to the securities transaction or a written trade confirmation



- of a broker-dealer relating to the securities transaction or a written trade confirmation prepared by the bank?
30. If customer notification is provided by furnishing the customer with a copy of the confirmation of a broker-dealer relating to the transaction, and if the bank is to receive remuneration from the customer or any other source in connection with the transaction, and the remuneration is not determined pursuant to a written agreement between the bank and the customer, does the bank also provide a statement of the source and amount of any remuneration to be received?
31. If customer notification is provided by furnishing the customer with a trade confirmation prepared by the bank, does the confirmation disclose:
- The name of the bank?
  - The name of the customer?
  - Whether the bank is acting as agent for such customer, as principal for its own account, or in any other capacity?
  - The date of execution and a statement that the time of execution will be furnished within a reasonable time upon written request of such customer?
  - The identity, price and number of shares of units (or principal amount in the case of debt securities) of such securities purchased or sold by such customer?
32. For transactions which the bank effects in the capacity of agent, does the bank, in addition to the above, disclose:
- The amount of any remuneration received or to be received, directly or indirectly, by any broker-dealer from such customer in connection with the transaction?
  - The amount of any remuneration received or to be received by the bank from the customer and the source and amount of any other remuneration to be received by the bank in connection with the transaction, unless remuneration is determined pursuant to a written agreement between the bank and the customer?
  - The name of the broker-dealer used. Where there is no broker-dealer, the name of the person from whom the security was purchased or to whom it was sold, or the fact that such information will be furnished within a reasonable time upon written request?
33. Does the bank maintain the above records and evidence of proper notification for a period of at least three years?
34. Does the bank furnish the written notification described above within five business days from the date of the transaction, or if a broker-dealer is used, within five business days from the receipt by the bank of the broker-dealer's confirmation? If not, does the bank use one of the alternative procedures described in Regulation H?
35. Unless specifically exempted in Regulation H, does the bank have established written policies and procedures ensuring:
- That bank officers and employees who make investment recommendations or decisions for the accounts of customers, who participate in the determination of such recommendations or decisions, or who, in connection with their duties, obtain information concerning which securities are being purchased or sold or recommended for such action, report to the bank, within 10 days after the end of the calendar quarter, all transactions in securities made by them or on their behalf, either at the bank or elsewhere in which they have a beneficial interest (subject to certain exemptions)?
  - That in the above required report the bank officers and employees identify the securities purchased or sold and indicate the dates of the transactions and whether the transactions were purchases or sales?
  - The assignment of responsibility for supervision of all officers or employees who (1) transmit orders to or place orders with broker-dealers, or (2) execute transactions in securities for customers?
  - The fair and equitable allocation of securities and prices to accounts when orders for the same security are received at approximately the same time and are placed for execution either individually or in combination?
  - Where applicable, and where permissible under local law, the crossing of buy and sell orders on a fair and equitable basis to the parties to the transaction?

**OTHER**

36. Are the preparation, additions, and posting of subsidiary records performed and/or adequately reviewed by persons who do not also have sole custody of securities?
37. Are subsidiary records reconciled, at least monthly, to the appropriate general ledger accounts and are reconciling items adequately investigated by persons who do not also have sole custody of securities?
38. Are fails to receive and deliver under a separate general ledger control?
  - a. Are fail accounts periodically reconciled to the general ledger, and any differences followed up to a conclusion?
  - b. Are periodic aging schedules prepared (if so, indicate frequency \_\_\_\_\_)?
  - c. Are stale fail items confirmed and followed up to a conclusion?
  - d. Are stale items valued periodically and, if any potential loss is indicated, is a particular effort made to clear such items or to protect the bank from loss by other means?
39. With respect to securities loaned and borrowed positions:

- a. Are details periodically reconciled to the general ledger, and any differences followed up to a conclusion?
  - b. Are positions confirmed periodically (if so, indicate frequency \_\_\_\_\_)?
40. Is the compensation of all department employees limited to salary and a non-departmentalized bonus or incentive plan?
    - a. Are sales representatives' incentive programs based on sales volume and not department income?

**CONCLUSION**

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

This section will help the examiner perform two separate, but related, functions:

- evaluate the depth and scope of the formalized policies and procedures the bank uses to manage and control its loan portfolio
- form an overview of the performance of the entire lending operation by consolidating the results of the examination programs from the various lending departments

### BANK LOAN POLICY

The purpose of a bank's lending policy is to establish the authority, rules, and framework to operate and administer its loan portfolio effectively, that is, to ensure profitability while managing risk. The policy serves as a framework to set basic standards and procedures in a clear and concise manner. The policy's guidelines should be derived from a careful review of internal and external factors that affect the institution, such as the bank's market position, historical experience, present and prospective trade area, probable future loan and funding trends, facilities, staff capabilities, and technology. Such guidelines, however, must be void of any discriminatory policies or practices.

The complexity and scope of the lending policy and procedures should be appropriate to the size of the institution and the nature of its activities and should be consistent with prudent banking practices and relevant regulatory requirements. Examiners should keep in mind that a loan policy that is appropriate for one bank is not necessarily suitable for another bank. Each bank's policy will differ, given the institution's strategic goals and objectives, coupled with factors such as economic conditions, the experience and ability of the lending personnel, and competition. The policy should be reviewed at least annually to ensure that it is not outdated or ineffective, remains flexible, and continues to meet the needs of the community. Changes in federal and other regulatory requirements also must be incorporated into the policy.

The policy should be broad and not overly restrictive. If carefully formulated and administered by senior management, and clearly communicated and understood through each level of

the organization, it greatly helps bank management (1) maintain sound credit-underwriting standards; (2) control and manage risk; (3) evaluate new business opportunities; and (4) identify, administer, and collect problem loans.

The lending policy must clearly state the philosophies and principles that govern safe and sound banking practices and procedures, as well as the mission and objectives of the particular institution. Throughout this manual, considerable emphasis is placed on formal written policies established by the board of directors that management can implement, administer, and amplify. The board of directors, in discharging its duty to both depositors and shareholders, must ensure that loans in the bank's portfolio are made based on the following three objectives:

- to grant loans on a sound and collectible basis
- to invest the bank's funds profitably for the benefit of shareholders and the protection of depositors
- to serve the legitimate credit needs of the bank's community

The written loan policy is the cornerstone for sound lending and loan administration. An adequate loan policy promotes—

- a bank's business and lending philosophy, despite changes in management;
- stability, as it provides a reference for lenders;
- clarity, to minimize confusion concerning lending guidelines; and
- sound objectives for evaluating new business opportunities.

The loan policy should define who will receive credit, what type, and at what price, as well as what credit documentation will be permitted or required. Other internal factors to be addressed include who will grant the credit and in what amount, as well as what organizational structure will ensure compliance with the bank's guidelines and procedures. Because loan authority is spread throughout the organization, the bank must have an efficient internal review and reporting system to monitor adherence to established guidelines. This system should adequately inform the directorate and senior management of how policies are being carried out and should

provide them with sufficient information to evaluate the performance of lending officers and the condition of the loan portfolio.

The loan policy should establish (1) what information will be required from the borrower during the application process, (2) what information the borrower will be required to submit while the credit remains outstanding, and (3) which bank personnel are responsible for obtaining the information. In addition, the policy should specify who is responsible for reviewing the adequacy of loan documentation and for citing and correcting documentation exceptions. A high level of documentation exceptions indicates a deficiency in the bank's policy, procedures, monitoring, or enforcement.

A loan policy will differ from loan procedures. A policy represents a plan, guiding principle, or course of action designed to establish a framework for handling decisions, actions, and other matters, thereby influencing them. A procedure is a set of established methods or steps for performing a task. The lending policy should include issues relevant to all departments of the bank. Written procedures approved and enforced in various departments should be referenced in the bank's general lending policy. The policy must be flexible enough to allow for fast adaptation to changing conditions in the bank's earning assets mix and trade area.

## Components of a Sound Lending Policy

As mentioned previously, a bank's loan policy should be appropriate to its size and complexity. Sound loan policy generally is based on the components described below.

*Allowance for loan and lease losses.* A sound lending policy establishes a systematic loan-review program to detect and identify problem loans and other portfolio weaknesses. (See the "Internal Loan Review" subsection for the requirements of a loan-review program.) Guidelines and methodologies need to be established to determine the adequacy of the bank's allowance for loan and lease losses (ALLL), and they should be based on a conservative analysis of the risk in the loan portfolio. This analysis should ensure that an appropriate ALLL is maintained. The 2006 Interagency Policy Statement on the Allow-

ance for Loan and Lease Losses<sup>1</sup> stipulates that federally insured depository institutions must maintain an ALLL at an appropriate level to absorb estimated credit losses associated with the loan and lease portfolio.

Examiners must evaluate management's estimate of losses existing in the bank's loan portfolio as well as the methodologies and procedures used in making and documenting the estimate. That evaluation provides the basis for determining the appropriateness and reasonableness of a bank's ALLL.

*Collections and charge-offs.* The lending policy should define the criteria and procedures for reporting relevant information concerning delinquent obligations to the board of directors. The policy should establish the mechanism for presenting problem loans to the directorate. Reports submitted to the board of directors should include sufficient detail for it to determine the risk factor, loss potential, and alternative courses of action. The policy should outline a follow-up collection notice procedure that is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by the board of directors or a board committee for charge-off.

*Concentrations of credit.* The lending policy should encourage both diversification within the portfolio and a balance between maximum yield and minimum risk. Concentrations of credit depend heavily on a key factor, and when weaknesses develop in that key factor, every individual loan within the concentration is affected. The directorate should evaluate the additional risk involved in various concentrations and determine which concentrations should be avoided or limited. The lending policy also should establish thresholds for acceptable concentrations of credit and require that all concentrations be reviewed and reported to the board on a periodic basis.

Institutions that have effective controls to manage and reduce undue concentrations over time need not refuse credit to sound borrowers simply because of the borrower's industry or geographic location. This principle applies to

1. See section 2070.1 (SR-06-17) and section 2072.1 (SR-01-17).

prudent loan renewals and rollovers, as well as to new extensions of credit that are underwritten in a sound manner. (See section 2050 for further details.)

*Consumer and equal credit opportunity laws.* Compliance with the many consumer-related laws, regulations, rulings, interpretations, and policy statements requires complex and detailed policies and procedures that should be addressed in a separate policy. However, the loan policy should require adherence to the Federal Reserve's Regulation B, 12 CFR 202, which implements the Equal Credit Opportunity Act. This regulation prohibits creditors from discriminating against loan applicants on the basis of age, race, color, religion, national origin, sex, marital status, or receipt of income from public assistance programs. As additional prohibitions are added under the regulation, they should be incorporated into the policy statement. Also, the loan policy should include a requirement that the bank give applicants a written notification of rejection of a loan application, a statement of the applicant's rights under the Equal Credit Opportunity Act, and a statement either of the reasons for rejection or of the applicant's right to such information.

*Credit files.* Obtaining and maintaining complete and accurate information on every relevant detail of a borrower's financial condition is essential to approving credit in a safe and sound manner. The loan policy should establish what information will be required from the borrower during the application process and what information the borrower will be required to submit while the credit remains outstanding. Credit files should be maintained on all borrowing relationships, regardless of size, with the exception of the latitude provided by the Interagency Policy Statement on Documentation of Loans. A current credit file should provide the loan officer, loan committee, and internal and external reviewers with all information necessary to analyze the credit before it is granted and to monitor and evaluate the credit during its life. Such information should (1) identify the borrower's business or occupation; (2) document the borrower's past and current financial condition; (3) state the purposes of all loans granted to the borrower, the sources of repayment, and the repayment programs; and (4) identify the collateral and state its value and the source of the valuation.

Credit files should include all financial statements, credit reports, collateral-inspection documents, reference letters, past loan applications, memoranda, correspondence, and appraisals. In many cases, particularly those involving real estate loans, appraisals and other collateral documentation may be maintained in a separate collateral file.

Documentation requirements will vary according to the type of loan, borrower, and collateral. For example, a bank may not require financial statements from borrowers whose loans are fully secured by certificates of deposit it issues. In a more general sense, information requirements between amortizing consumer loans and commercial or real estate loans vary greatly. More specific examples of the types and frequency of financial information often obtained for various types of credit are detailed in the following paragraphs.

For many consumer installment and residential mortgage loan borrowers, the borrowers' financial information generally is collected only at the time of loan application. The underwriting process for these types of loans emphasizes factors such as the borrower's income and job stability, credit history, and debt load, as well as the loan-to-value requirements for obtained collateral.

In factoring and other asset-backed lending activities, while financial information is a significant part of the underwriting process, collateral is the key component of the lending decision. Close monitoring of the collateral's existence, value, and marketability are essential to sound underwriting of these types of loans.

For typical commercial, commercial real estate, and agricultural loans, significant emphasis is placed on the financial strength, profitability, and cash flow of the core business for loan repayment. Close monitoring of the business's financial condition and profitability throughout the life of the loan is key to the sound administration of these types of credits. Other pertinent information requirements, such as collateral-inspection documentation for agricultural credits or lease/rental information for income-producing commercial real estate credits, may also be necessary to properly administer these loans. As part of the sound underwriting process for these loans, a bank may include loan covenants requiring the business to maintain financial soundness, submit periodic financial statements, and provide other needed information.

As a practice, a bank should not ask for information it does not need to adequately underwrite and monitor the quality of its loans. With proper use of loan covenants, a bank can protect its right to receive additional or more frequent information if a borrower's financial condition deteriorates or collateral values decline. When determining the financial and other information to request from the borrower, bankers should consider the requirements of the underwriting process for particular types of loans and the repayment risks. A bank's loan policy should clearly delineate the type and frequency of such information requirements.

The lending policy also should define the financial-statement requirements for businesses and individuals at various borrowing levels. Specifically, requirements for audited, unaudited, annual, or interim balance sheets; income and cash-flow statements; statements of changes in capital accounts; and supporting notes and schedules should be included, as appropriate. In addition, the lending policy should require external credit checks as appropriate, at the inception of the loan and during periodic updates. The loan policy should be written so that credit-data exceptions would be a violation of the policy.

*Distribution by category.* Limitations based on aggregate percentages of total loans in commercial, real estate, consumer, or other categories are common. Aggregate percentages for loans to deposits, assets, and capital (with regard to concentrations of credit) would provide guidance for effective portfolio management. Such policies are beneficial but should allow for deviations, with the approval by the board or a board committee. This allows credit to be distributed in response to the community's changing needs. During times of heavy loan demand in one category, an inflexible loan-distribution policy would cause that category to be slighted in favor of another.

*Exceptions to the loan policy.* A lending policy should require loan officers to present credits they believe are fundamentally sound and worthy of consideration, even though they may not conform with the bank's written lending policy or procedures. The reason for the exception should be detailed in writing and submitted for approval to a designated authority. The directors' loan committee or a similar body should review and approve all exceptions at reasonable intervals. The frequency of exceptions granted

may indicate a lessening of underwriting standards on the one hand, or a need to adjust the policy to allow flexibility within safe and sound parameters on the other. The underlying reasons behind frequently granted exceptions should be assessed, and appropriate recommendations should be made accordingly.

*Financing other real estate.* If the bank wants to finance a parcel of other real estate that it owns, special accounting rules may apply. Consequently, the lending policy should include an outline of certain provisions of Financial Accounting Standards Board (FASB) Statement No. 66, "Accounting for Sales of Other Real Estate."

*Geographic limits.* A bank's trade area should be clearly delineated and consistent with defined Community Reinvestment Act (CRA) criteria. Loan officers and directors should be fully aware of specific geographic limitations for lending purposes. The bank's defined trade area should not be so large that, given its resources, the bank cannot properly and adequately monitor and administer its credits. A sound loan policy restricts or discourages loan approval for customers outside the trade area. The bank's primary trade area should be distinguished from any secondary trade area, which is especially important for new banks. Specific restrictions or exceptions should be listed separately.

*Lender liability.* Banking organizations must be careful that their actions to make, administer, and collect loans—including assessing and controlling environmental liability—cannot be construed as taking an active role in the management or day-to-day operations of the borrower's business. Such actions could lead to potential liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA). (See the "Environmental Liability" subsection.)

*Limitation on aggregate outstanding loans.* Banks should establish guidelines limiting the total amount of loans outstanding in relation to other balance-sheet accounts. This type of control over the loan portfolio usually is expressed relative to deposits and total assets. In setting such limitations, various factors, such as the credit demands of the community, the volatility of deposits, and the credit risks involved, must be considered.

*Loan authority.* The lending policy should establish limits for all lending officers and ensure controls are in place to monitor compliance with the bank's legal lending limit. An individual officer's lending limit is usually based on his or her experience, tenure, and past adherence to the bank's loan policy. Lending limits also should be set for group authority, thereby allowing a combination of officers or a committee to approve larger loans than the members would be permitted to approve individually. The loan policy should describe the manner in which loans will be approved and ultimately reported to the board of directors, as well as the frequency of any loan committee meetings, as applicable.

*Loan pricing.* At a minimum, interest rates on loans must be sufficient to cover (1) the cost of the funds loaned, (2) the bank's loan services (including general overhead), and (3) probable losses—while providing for a reasonable profit margin. Policymakers must know these costs before establishing rates. Periodic review allows rates to be adjusted in response to changes in costs, competitive factors, or risks of a particular type of extension of credit. Specific guidelines for other relevant factors, such as compensating-balance requirements and fees on commitments, are also germane to pricing credit.

*Loan purchases and sales.* If sufficient loan demand exists, lending within the bank's trade area is safer and less expensive than purchasing paper from a dealer or a correspondent bank. Direct lending promotes customer relationships, serves the credit needs of customers, and develops additional business. Occasionally, a bank may not be able to advance a loan to a customer for the full amount requested because of individual state lending limitations or other reasons. In such situations, the bank may extend credit to a customer up to its internal or legal lending limit and sell a participation to a correspondent bank for the amount exceeding the bank's lending limit or the amount it wishes to extend on its own. Generally, such sales arrangements are established before the credit is ultimately approved. These sales should be on a nonrecourse basis by the bank, and the originating and purchasing banks should share in the risks and contractual payments on a pro rata basis. Selling or participating out portions of loans to accommodate the credit needs of customers promotes goodwill and enables a bank to retain customers

who might otherwise seek credit elsewhere.

Conversely, many banks purchase loans or participate in loans originated by others. In some cases, such transactions are conducted with affiliates or members of a chain-banking organization, with the goal of benefiting the whole organization. A purchasing bank may also wish to supplement its loan portfolio when loan demand is weak. In still other cases, a bank may purchase or participate in a loan to accommodate an unrelated originating bank with which it has an ongoing business relationship.

Purchasing or selling loans, if done properly, can have a legitimate role in a bank's overall asset and liability management and can contribute to the efficient functioning of the financial system. In addition, these activities help a bank diversify its risks and improve its liquidity.

Banks should avoid purchases of loans that generate unacceptable concentrations of credit. Such concentrations may arise solely from the bank's purchases, or they may arise when loans or participations purchased are aggregated with loans originated and retained by the purchasing bank. The policy should state the limits (1) for the aggregate amount of loans purchased from and sold to any one outside source and (2) of all loans purchased and sold. It should also establish limits for the aggregate amount of loans to particular types of industries. The extent of contingent liability, holdback and reserve requirements, and the manner in which loans will be handled and serviced should be clearly defined. In addition, the policy should require that loans purchased from another source be evaluated in the same manner as loans originated by the bank itself. Guidelines should be established for the type and frequency of credit and other information the bank needs to obtain from the originating institution to keep itself continually updated on the status of the credit. Guidelines should also be established for supplying complete and regularly updated credit information to the purchasers of loans originated and sold by the bank.

*Loans to employees, officers, directors, principal shareholders, and their related interests.* Loans to insiders are strictly defined in federal statutes and require close supervision to ensure compliance. Federal and state statutes provide the basis for defining insider loans, and they specify requirements and limitations that should be incorporated in the policy. (See the Federal Reserve's Regulation O, 12 CFR 215.)

The policy should ensure, through a system of controls over authority and funding, that extensions of credit to insiders are legally permissible and that they are made on substantially the same terms and conditions as those prevailing at the time for comparable transactions with other borrowers. Furthermore, the policy should contain guidelines for loans to employees who are not subject to the provisions of Regulation O.

*Maximum maturities.* Loans should be granted with realistic repayment plans, with the maturity related to the anticipated source of repayment, the purpose of the loan, and the useful life of the collateral. For term loans, a lending policy should state the maximum number of months over which loans may be amortized. Specific procedures should be developed for situations requiring balloon payments and modification of original loan terms. If the bank requires a cleanup (out-of-debt) period for lines of credit, it should be stated explicitly.

*Maximum ratio of loan amount to collateral value.* The loan policy should set forth procedures for ordering, preparing, and reviewing appraisals for real or personal property pledged as collateral. The bank's lending policy should outline guidelines for appraisals or internal evaluations, including regulatory requirements, and, in the case of renewals or extensions, procedures for possible reappraisals or re-evaluations. Acceptable types of appraisals or evaluations should be outlined. Circumstances requiring the use of in-house staff appraisers instead of fee appraisers should be identified. Maximum loan-to-value ratios and the methods of valuation to be used for various types of collateral should be detailed. (See sections 2090 and 2100 for further details.)

The maximum ratio of loan amount to the market value of pledged securities is restricted by the Federal Reserve's Regulation U, 12 CFR 221. The lending policy should set forth margin requirements for all types of securities acceptable as collateral. Margin requirements should be related to the marketability of the security, that is, whether it is actively traded, over the counter, or closely held. The policy also should assign responsibility and set a frequency for periodic pricing of the collateral.

*Prohibitions against tying arrangements.* In a tying arrangement, the extension of credit, provision of a service, or consideration for credit or

service generally is varied or conditioned upon a customer's obtaining or providing some additional product or service from or to the bank or an affiliate. Section 106(b) of the Bank Holding Company Act Amendments of 1970 generally prohibits a bank from tying a product or service to any of its other products or services, including those offered by its affiliates. Certain tying arrangements are permissible when the two products tied are loans, deposits, or trust services available from the same bank or when the Board has determined that a particular tying arrangement is permissible.<sup>2</sup> To the extent possible, examiners should ascertain that member banks have not extended credit voluntarily or involuntarily based on impermissible tying arrangements.

*Types of loans.* The lending policy should state the types of loans management considers desirable or prohibited. It also should set forth guidelines for extensions-of-credit types such as commercial loans; real estate loans; secured and unsecured loans; and off-balance-sheet activities, such as letters of credit and loan commitments. The decision about the types of loans granted should be based on the expertise of the lending officers, the deposit structure of the bank, and the community's anticipated credit demands. Credits involving complex structures or repayment arrangements, or loans secured by collateral that requires more-than-normal monitoring, should be avoided unless the bank has the personnel, policies, controls, and systems necessary to administer such advances properly. Types of credits that have caused an abnormal loss to the bank should be identified, scrutinized, and controlled within the framework of stated policy. A bank also should consider its overall exposure to term lending relative to its stable funds.

*Continued rigorous credit-risk assessment during favorable economic conditions.* Internal processes and requirements for loan-underwriting decisions should be consistent with the nature, size, and complexity of the banking organization's activities and with the institution's lending policies. Any departures therefrom can have serious consequences for institutions of all sizes. (See SR-99-23.) Departures can be evident in three pivotal and related areas:

2. See SR-95-32.



1. *An undue reliance on optimistic outlooks for prospective borrowers and for continued favorable economic and financial market conditions.* A long and continuing economic expansion can lead banks to more frequently base their decision to lend on a very optimistic assessment of the borrower's operating prospects. Timely principal repayment may often be based on the assumption that the borrower will have ready access to financial markets in the future. Such reliance, especially if across a significant volume of loans, is not consistent with sound credit-risk management. Undue reliance on continued favorable economic conditions can be demonstrated by—

- dependence on very rapid growth in a borrower's revenue as the "most likely" case;
- heavy reliance on favorable collateral appraisals and valuations that may not be sustainable over the longer term;
- greater willingness to make loans without scheduled amortization before the loan's final maturity; or
- ready willingness to waive violations of key covenants, release collateral, or guarantee requirements, or even to restructure loan agreements, without corresponding concessions on the part of the borrower on the assumption that a favorable environment will allow the borrower to recover quickly.

Among the adverse effects of undue reliance on a favorable economy is the possibility of delay in properly identifying problem loans. Timely identification of problem loans is critical for providing a full awareness of the institution's risk position, informing management and directors of that position, taking steps to mitigate risk, and properly assessing the adequacy of the allowance for credit losses and capital.<sup>2a</sup>

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2a. With respect to these issues, see SR-98-25, "Sound Credit Risk Management and the Use of Internal Credit Risk Rating Systems at Large Banking Organizations"; SR-99-22, "Joint Interagency Letter on the Loan Loss Allowance"; and SR-99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles." As discussed therein, the Federal Reserve's guidance on credit-risk management and mitigation covers both loans and other forms of on- and off-balance-sheet credit exposure.

Underlying a banking organization's (BO) overly optimistic assessment of a borrower's prospects may be an overreliance on its continued ready access to financial markets on favorable terms. Examples of overreliance include the following:

- explicit reliance on future, public market debt or equity offerings or on other sources of refinancing as the ultimate source of principal repayment, which presumes that market liquidity and the appetite for such instruments will be favorable at the time that the facility is to be repaid
- ambiguous or poorly supported BO analysis of the repayment sources of the loan's principal (This results in an implicit reliance, for repayment, on some realization of the implied market valuation of the borrower (for example, through refinancing, asset sales, or some form of equity infusion) and presumes, as above, that markets will be receptive to such transactions at the time that the facility is to be repaid.)
- measuring a borrower's leverage (for example, debt-to-equity) based solely on the market capitalization of the firm without regard to "book" equity, and thereby implicitly assuming that currently unrealized appreciation in the value of the firm can be readily realized if needed
- more generally, extending bank loans with a risk profile that more closely resembles that of an equity investment and under circumstances in which additional bank credit or default are the borrower's only resort if favorable expectations are not met

As a result of this overreliance, some banking organizations may find themselves with a potentially significant concentration of credit exposure that is at risk to a possible reversal in financial markets. Turmoil in financial markets, however, may contribute to significant liquidity pressures in some sectors of the economy and prevent ready access to financial markets by certain borrowers. Moreover, there is no assurance that any such market turmoil will quickly resolve itself. Under these circumstances, a borrower's ability to raise new funds in public debt or equity markets to repay maturing bank loans is far from guaranteed.

2. *Insufficient consideration of stress testing.*

An institution's lending policies should prescribe meaningful stress testing of the prospective borrower's ability to meet its obligations. Failure to recognize the potential for adverse events—whether specific to the borrower or its industry (for example, a change in the regulatory climate or the emergence of new competitors) or to the economy as a whole (for example, a recession)—can prove costly to a banking organization.

Mechanical reliance on threshold financial ratios (and the “cushion” they imply) is generally not sufficient, particularly for complex loans and loans to leveraged borrowers or others that must perform exceptionally well to meet their financial obligations successfully. Scenario analysis specific to the borrower, its industry, and its business plan is critical to identify the key risks of a loan. Such analysis should have a significant influence on both the decision to extend credit at all and, if credit is extended, on decisions on appropriate loan size, repayment terms, collateral or guarantee requirements, financial covenants, and other elements of the loan's structure.

When properly conducted, meaningful stress testing includes assessing the effect on the borrower when the following situations or events occur:

- unexpected reductions or reversals in revenue growth, including shocks to revenue of the type (or types) and magnitude that would normally be experienced during a recession
- unfavorable movements in market interest rates, especially for firms with high debt burdens
- unplanned increases in capital expenditures due to technological obsolescence or competitive factors
- deterioration in the value of collateral, guarantees, or other potential sources of principal repayment
- adverse developments in key product or input markets
- reversals in or reduced access by the borrower to public debt and equity markets

Proper stress testing typically incorporates an evaluation of the borrower's alternatives for meeting its financial obligations under each scenario, including asset sales, access to alternative funding or refinancing, or ability

to raise new equity. In particular, the evaluation should focus not only on the borrower's ability to meet near-term interest obligations, but also on its ability to repay the principal of the obligation.

3. *Weakening of key internal controls in the lending process.* An institution's lending policy should require the use of adequate internal controls within the lending process. Internal controls such as loan review or credit audit are critical for maintaining proper incentives for bank staff to be rigorous and disciplined in their credit analysis and lending decisions. A bank's credit analyses, loan terms and structures, credit decisions, and internal rating assignments should be reviewed in detail by experienced and independent loan-review staff. These reviews provide both motivation for better credit discipline within an institution and greater comfort for examiners—and management—that internal policies are being followed and the institution continues to adhere to sound lending practice.

Economic prosperity and relatively low levels of problem loans and credit losses should not encourage institutions to dramatically or suddenly reduce staff resources or portfolio coverage for the loan-review function. Likewise, thorough reviews of individual loans should continue. When economic prosperity and relatively low levels of problem loans and credit losses exist, there may be increasing internal pressure within the institution to reduce loan-review staff, to conduct more limited loan portfolio reviews, and to perform less thorough reviews of individual loans. Although some useful efficiencies may be desired, the danger is that the scope and depth of loan-review activities may be reduced beyond prudent levels over a longer horizon. If reduced too far, the integrity of the lending process and the discipline of identifying unrealistic assumptions and discerning problem loans in a timely fashion may deteriorate, particularly as a result of a downturn in a credit cycle.

*Other.* Management should establish appropriate policies, procedures, and information systems to ensure that the impact of the bank's lending activities on its interest-rate exposure is carefully analyzed, monitored, and managed. In this regard, consideration should also be given to

off-balance-sheet instruments that may be associated with lending arrangements, including commitments, letters of credit, or swaps. (See section 4110.1 for further details.)

Under the provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), a financial institution is required to develop, adopt, and maintain policies, procedures, and guidelines consistent with safe and sound banking practices. The federal banking agencies have issued interagency guidelines based on the provisions. Taken together, these guidelines should strengthen supervision of financial institutions and provide guidance in developing and maintaining policies:

- Regulation H—subpart E, 12 CFR 208.50–51
- Regulation Y—subpart G, 12 CFR 225.61–67
- Uniform Standards of Professional Appraisal Practice promulgated by the Appraisal Standards Board of the Appraisal Foundation
- Interagency Appraisal and Evaluation Guidelines (See SR-10-16 and SR-94-35.)
- Interagency Guidance on Accounting for Disposition of Other Real Estate Owned (See SR-93-42.)
- Interagency Policy Statement for Loan and Lease Losses (See SR-06-17.)
- Interagency Policy Statement on Supervisory Initiatives/Credit Availability (See SR-93-30.)
- Interagency Policy Statement on Documentation of Loans (See SR-93-26.)
- Regulation Y, section 225.7 “Tying Restrictions” (12 CFR 225.7.)

An institution’s policies and procedures as they relate to interagency statements should be reviewed as part of the examination of the institution’s overall lending activities.

## PROHIBITIONS AGAINST TYING ARRANGEMENTS

Section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 USC 1972(b)) generally prohibits a bank from conditioning the availability or price of one product or service (the *tying product*) on a requirement that the customer obtain another product or service (the *tied product*) from the bank or an affiliate of the bank. The central purpose of section 106(b) is to

prevent banks from using their market power in banking products, including credit, to gain an unfair competitive advantage in other products. The restrictions of section 106(b) on banks are broader than those of the antitrust laws, as no proof of economic power in the tying-product (or desired-product) market or anticompetitive effects in the tied-product market are required for a violation to occur. Although banks, like their nonbank competitors, are subject to general antitrust prohibitions on tying, section 106 was enacted because Congress concluded that special restrictions were necessary given the unique role of banks in the economy.

The intent behind section 106(b) is to affirm the principles of fair competition by eliminating the use of tying arrangements that have the potential to suppress competition. A prohibited tie-in can occur if a bank (1) varies the consideration (that is, the amount charged) for a bank product or service (the *tying product*) on the condition that a customer obtain another product or service (the *tied product*) from the bank or its affiliate or (2) requires a customer to purchase another product or service from the bank or any of its affiliates as a condition for providing a product or service to the customer.

Section 106(b) of the Bank Holding Company Act Amendments has five restrictions that are applicable to banks. The first two restrictions prohibit conditions constituting traditional tying arrangements; restrictions three and four prohibit reciprocal-dealing arrangements; and the fifth, with certain exceptions, prohibits an exclusive-dealing arrangement. Exempted from these prohibited conditional transactions are *traditional bank products*. Specifically, section 106(b) prohibits a bank, in any manner, from fixing or varying the consideration for extending credit, leasing or selling property of any kind, or furnishing any service on the condition or requirement that the customer—

- obtain additional credit, property, or service from the bank, other than a loan, discount, deposit, or trust service (a *traditional bank product*);
- obtain additional credit, property, or service from the bank’s parent holding company or other subsidiaries;
- provide additional credit, property, or service to the bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;
- provide additional credit, property, or service

to the bank's parent holding company or any of the holding company's other subsidiaries; or

- not obtain other credit, property, or service from the competitors of the bank, the bank's parent holding company, or the holding company's other subsidiaries, except that the lending bank may reasonably impose conditions and requirements in a credit transaction to ensure the soundness of the credit.

As stated above, section 106(b) prohibits reciprocity arrangements. In a reciprocity arrangement, a bank conditions the availability of, or varies the consideration of, one product on a customer's provision of another product to the bank or one of its affiliates. The statutory prohibition on reciprocity arrangements contains an exception intended to preserve traditional banking practices. The exception provides that a bank may condition the availability of a product or service on a customer's providing to the bank some product or service "related to and usually provided in connection with" a loan, discount, deposit, or trust service.<sup>3</sup>

Because a subsidiary of a bank is considered to be part of the bank for most supervisory and regulatory purposes under the federal banking laws, the restrictions in section 106(b) generally apply to tying arrangements imposed by a subsidiary of a bank in the same manner that the statute applies to the parent bank itself. Thus, a subsidiary of a bank is generally prohibited from conditioning the availability or price of a product on a customer's purchase of another product from the subsidiary, its parent bank, or any affiliate of its parent bank. Section 106(b) generally does not apply to tying arrangements imposed by a nonbank *affiliate* of the bank.

## Exceptions

### *Statutory Exception*

There is a statutory exception to the anti-tying restrictions. The statutory *traditional-bank-product exception* of section 106(b) permits a bank to tie any product to a traditional bank product (a loan, discount, deposit, or trust service) offered by that bank, but not by any

3. The 1997 Regulation Y revisions extended this statutory exception to cover reciprocity requirements imposed by banks that require customers to provide a "usually related" product or service to an affiliate of the bank.

affiliated bank or nonbank. For example, a bank could condition the use of its messenger service on a customer's maintaining a deposit account at the bank. Section 106(b) also grants the Board the authority to prescribe exceptions by regulation or order when it determines that an exception will not be contrary to the purposes of this section.

### *Regulatory Exceptions*

*Traditional-bank-product exception.* The traditional-bank-product exception of Regulation Y (12 CFR 225.7(b)(1)) permits a bank to extend credit, lease or sell property, provide any service, or fix or vary its consideration on the condition that a customer obtain a traditional bank product (a loan, discount, deposit, or trust service) from an affiliate of the bank. This regulatory exception is a limited extension of the traditional-bank-product exception provided in section 106(b) and is coextensive with the statutory exception.

*Combined-balance discount.* On April 19, 1995 (effective May 26, 1995), the Board issued a revised rule on the anti-tying provisions of section 106 of the Bank Holding Company Act Amendments of 1970.<sup>4</sup> The rule established a *combined-balance discount* safe harbor for a banking organization offering varieties of services to its customers and wishing to offer them discounts based on the customers' overall relationship with the bank or its holding company and subsidiaries. A bank may vary the consideration for any product or package of products based on a customer's maintaining a combined minimum balance in certain products specified by the bank (eligible products)<sup>5</sup> if—

4. With the Board's approval of the 1997 revisions to Regulation Y, tie-in prohibitions were eliminated for BHCs and their nonbank subsidiaries, except when electronic benefit transfer services are provided. BHCs and their nonbank subsidiaries are still subject to anti-tying restrictions with respect to electronic benefit transfer services, as set forth in 7 USC 2016(h)(11).

5. Eligible products under the safe harbor are those "products specified by the bank" as part of the combined-balance discount program. (See 12 CFR 225.7(b)(2).)

- the bank offers deposits, and all such deposits are eligible products, and
- balances in deposits count at least as much as nondeposit products toward the minimum balance.

### *Board Staff Opinions on Exceptions to the Anti-tying Restrictions*

*Offering insurance products in a combined-balance discount program.* A question was raised as to whether insurance products may be included among the products offered by a bank as part of a combined-balance discount program (eligible products) operated pursuant to the Board's safe harbor, if the program otherwise meets the requirements of the safe harbor. If insurance products are deemed to be eligible products, it was also questioned whether the principal amount of annuity products may be counted towards the minimum balance, and whether insurance premiums may be counted towards the minimum balance for non-annuity insurance products.

Board staff issued the following response to the questions: To qualify for the Board's safe harbor, all deposits must be eligible products under the combined-balance discount program, and deposit balances must be weighed at least as much as nondeposit products towards the minimum balance.<sup>6</sup> The Board's requirement that deposit balances be weighed at least as much as nondeposit products towards the minimum balance was included in the safe harbor to allow banks and their affiliates to price products they include in a combined-balance program in an economically rational way—while limiting the bank's ability to use product weighting to require the purchase of certain nontraditional products. This requirement specifically provides for the inclusion of certain products with values that could be greater than the typical retail deposit, while allowing deposits to remain a viable way for customers to reach the minimum balance.

On this basis, any financial products offered by a bank or its affiliates, including insurance products, may be properly included among the eligible products in that bank's combined-balance discount program. The principal amount of an annuity may be counted in determining the

size of the customer's balance in eligible products, as may the premiums paid in a given policy year on non-annuity insurance products. The principal amount of an annuity is closely analogous to the principal amount of a deposit, as both represent a customer's initial cash investment with the relevant financial institution. Similarly, insurance premiums are money actually paid by the customer to the insurance underwriter.

*Combined-balance discount—Members of a household or family, taken together, may constitute a "customer."* A BHC's legal counsel raised a question as to whether members of a household or family, taken together, may be considered a "customer" for purposes of the combined-balance discount safe harbor set forth in section 225.7(b) of Regulation Y. The BHC desired to offer its customers discounts on the products and services of its subsidiary banks if a customer's household maintains a specific minimum balance with its banks and their affiliates. The minimum balance would be computed by adding the balances held by an individual customer in products (both bank and nonbank) specified by the company's affiliated bank, including deposits, to balances held in the same products by all other members of that customer's household.

Board staff noted that the safe harbor would be available only if all deposits are eligible products under the combined-balance discount program and deposit balances are weighed at least as much as nondeposit products towards the minimum balance. Board staff also noted that aggregating balances held at the BHC's affiliates by members of a family or household would make it easier for customers to achieve the minimum balance necessary to receive the favorable pricing on bank products and services, and thus appears to be pro-consumer and not anticompetitive.

Accordingly, Board staff opined in a November 26, 2002, letter that the term *customer*, as used in section 225.7(b)(2) of Regulation Y, may include separate individuals who (1) are all members of the same immediate family (as defined in section 225.41(b)(3) of Regulation Y) and (2) reside at the same address. Staff also indicated that the program must not be operated in an anticompetitive manner.

*A BHC's subsidiary banks issuing securities-based credit can require borrowers to keep the securities collateral in an account at the BHC's*

6. As previously noted, eligible products are those "products specified by the bank" as part of the combined-balance discount program.

*broker-dealer affiliate.* A BHC's legal counsel requested that the Board grant an exception to the anti-tying prohibitions of section 106 of the Bank Holding Company Act Amendments of 1970. The exception would allow the subsidiary banks (the banks) of the BHC to require borrowers whose bank loans are secured with publicly traded securities to keep those securities in accounts at the BHC's broker-dealer affiliate.

The request stated that the banks often make loans that are collateralized by marketable securities, and that these securities are generally held in accounts at broker-dealers unaffiliated with the BHC, subject to collateral agreements. The BHC requested its subsidiary banks be granted an exception from section 106 that would allow them to require borrowers to keep securities pledged as loan collateral from the banks in an account at a broker-dealer affiliate. The requirement would give the BHC more control over the collateral (for example, to prevent it from being sold or exchanged for different securities) and would allow the BHC to monitor the value of the collateral more closely than when the securities are held at an unaffiliated institution.

The Board's August 18, 2003, response to the request was as follows: Section 106 allows the banks to require borrowers to place securities pledged as collateral in trust accounts at the banks. A specific exception in section 106 allows banks to condition the availability of any product, including credit, on the customer's obtaining a trust service. The BHC preferred, however, to use the systems for holding and monitoring securities in brokerage accounts at its broker-dealer affiliate for reasons based on cost, efficiency, and improved monitoring. The banks, it was contended, would receive more cooperation when inquiring about the status of securities pledged as collateral from the BHC's broker-dealer affiliate than they would receive from unaffiliated broker-dealers, who have little incentive to help the banks protect their collateral.

The BHC made the following representations in support of its request: (1) The banks would only require the customer to use an account of the BHC's broker-dealer affiliate for the purpose of holding securities that collateralize a loan from the banks; (2) no securities other than those pledged as collateral for a loan from the banks *could* be held in these accounts; and (3) securities held in these accounts could not be traded by the customer without the prior approval of the BHC's credit department for

each trade.<sup>7</sup> These restrictions would both protect the banks' interest in and the value of the collateral pledged and ensure that the banks do not require customers to establish brokerage accounts for a purpose other than protecting bank collateral. The BHC proposed to require the use of affiliated broker-dealer accounts solely for the purpose of securing and monitoring collateral pledged for loans extended by the banks to their account holders.

The Board's response letter stated that (1) section 106 permits this practice when securities collateralizing a loan are maintained in trust accounts in the banks or their affiliates or are otherwise provided to and held by the banks; (2) the proposal would not appear to give the BHC any competitive advantage over other broker-dealers in obtaining general securities brokerage business from customers; and (3) the described restrictions would cause the securities accounts at the broker-dealer to be the functional equivalent of bank trust accounts, in which the banks currently may require borrowers to place securities used to collateralize loans. The Board's response also stated that the Board continues to evaluate whether the BHC's proposed program is prohibited by section 106. Subject to this potential determination, the Board believed that granting an exception for the program would not be contrary to the purposes of section 106. The response noted that the limitations on when an affiliated broker-dealer account would be required and how the account would be used help ensure that the accounts at the BHC's broker-dealer affiliate would only be used to preserve customers' collateral pledged for loans and would not be used to gain a competitive advantage over the broker-dealer affiliate's competitors, particularly because a customer's ability to trade in the account would be severely restricted. Accordingly, on this basis, the Board granted an exception to the restrictions of section 106 for the BHC's proposed program. Approval of the exception was subject to the restrictions on the relevant accounts at the BHC's broker-dealer affiliate described in the BHC's request and in its correspondence, and to the Board's potential determination that the proposed requirement is not in fact subject to section 106. Any changes in the facts and representations are to be reported to Board staff.

7. The BHC will not give customers permission to trade generally through these accounts.

*Bank customers receiving securities-based credit can be required to hold securities collateral at a broker-dealer affiliate account.* A bank's external legal counsel inquired about the application of section 106 to certain lending programs offered by the bank and its broker-dealer affiliate. In a letter dated February 2, 2004, Board staff responded that section 106 does not prohibit a bank from requiring borrowers that obtain securities-based credit from the bank to keep the securities collateral in an account at a bank's broker-dealer affiliate, so long as the collateral requirement is limited in scope.

The inquiry stated that the bank and its broker-dealer affiliate offer securities-based loans—that is, loans collateralized by securities or other marketable investment assets (securities)—subject to the requirement that the securities collateralizing the loans be kept in collateral accounts with their broker-dealer affiliate.<sup>8</sup> The inquiry also stated that customers are (1) not charged for establishing or maintaining the collateral accounts or for transferring securities to the collateral accounts; (2) not obligated to trade in the collateral accounts or any other accounts or to purchase any other products or services from the bank, its affiliate, or the broker-dealer affiliate, or any of their affiliates; (3) not required to maintain any securities in the collateral accounts beyond those necessary, in the bank's credit judgment or that of its affiliate, as the case may be, to support the credit extensions;<sup>9</sup> (4) required to obtain prior approval from the bank or its affiliate, as appropriate, before withdrawing assets from the collateral accounts; (5) not charged a fee for effecting such withdrawals; and (6) required to ensure that the value of the securities in the collateral account equals or exceeds the lender's (the bank or its broker-dealer affiliate) collateral requirement for the loan on an ongoing basis.

Board staff responded by stating that section 106 generally prohibits a bank from conditioning the availability or price of a product on a

requirement that the customer obtain another separate product from, or provide another separate product to, the bank or an affiliate of the bank. Board staff stated that it believed the securities-based lending programs, when conducted in the manner described in the inquiry and in the bank's correspondence with the Board, are permissible under and consistent with the purposes of section 106. In support of this determination, Board staff stated that (1) by requiring collateral for a securities-based loan, the bank and its broker-dealer affiliate are not requiring that the customer obtain any product separate from the loan itself and (2) the fact that the bank and its affiliate require the pledged securities to be held in an account at an affiliate does not make the collateral or the account a product separate from the loan that the collateral secures. The Board's staff opinion was not altered by the fact that (1) borrowers are permitted to hold securities in the collateral account beyond those minimally required to satisfy the lender's collateral requirement and to trade securities in the collateral;<sup>9a</sup> (2) a customer must pay the broker-dealer affiliate its standard brokerage commission if the customer decided to effect trades in the collateral account;<sup>9b</sup> or (3) in the event that the value of the securities in the collateral account falls below the lender's collateral requirement for the related loan, the customer must eliminate the collateral shortfall.

## LOAN ADMINISTRATION

*Loan administration* is a term that refers to several aspects of lending. It can be used to describe the entire credit-granting process, as well as the monitoring of various lending activities, such as ensuring that loans remain adequately collateralized, properly graded, and appropriately serviced (administered). The ser-

8. The inquiry stated that the bank and its broker-dealer affiliate generally allow customers to trade securities held in the collateral accounts (however, see footnote 3 of the response letter) and that the broker-dealer affiliate charges customers its standard brokerage fee for any trades made by customers that involve securities held in the collateral accounts. Customers are also not restricted in their ability to maintain brokerage accounts with other securities firms not affiliated with the bank or its affiliate.

9. All securities in the collateral accounts are pledged as collateral to support the securities-based loans extended by the bank or its affiliate.

9a. Allowing a customer to trade securities or to place excess securities in a collateral account underlying a securities-based loan enhances customer choice without reducing the integral connection between the loan and the collateral account. The inquiry represented that the customer is *allowed* to trade and deposit excess securities in the account, and the customer is not *required* to trade or deposit excess securities. Thus, any trading in the account or placement of excess securities in the account is voluntary.

9b. A customer is not required to trade in the account, and trades effected by the customer in the account generally would be unrelated to the loan.

vicing of an extension of credit involves tasks ranging from obtaining current financial information to sending out renewal notices and preparing loan agreements. In addition to facilitating the entire lending process, the individual tasks also serve as controls (checks and balances) over the lending activities. Given the wide breadth of responsibilities that the loan-administration function encompasses, its organizational structure varies with the size and sophistication of the bank. In larger banks, responsibilities for the various components of loan administration are usually assigned to different departments, while in smaller institutions, a few individuals might handle several of the functional areas. For example, a large bank's independent credit department may be responsible for analyzing borrowers' financial information, making a determination or recommendation as to the quality of the loan (its risk rating or grade), or obtaining/following up on credit-related information and documentation. On the other hand, smaller banks may assign each of these tasks to individual loan officers.

Examiners will encounter many different organizational structures for loan administration. Therefore, when considering the safety and soundness of a bank, they should determine whether it has effective and appropriate internal controls in place. The assessment of loan administration and related internal controls involves evaluating the bank's operations by reviewing the—

- efficiency and effectiveness of loan-administration operations;
- ability of the different components to safeguard assets, primarily loans and leases;
- adequacy of the management information systems and the accuracy of their reporting;
- adequacy and accuracy of its loan-review function (discussed in the next subsection); and
- compliance with prescribed management policies, procedures, applicable laws, and regulations.

For the components of loan administration to function appropriately, management must understand and demonstrate that it recognizes the importance of controls. This includes not only establishing appropriate policies and procedures but also enforcing them and ensuring that the bank's organizational structure is suitable for its

size and complexity. Managers should emphasize integrity and ethical values, as well as hire competent staff. In addition, the following factors positively influence loan-administration control:

- a board of directors and/or senior management that takes an active role in monitoring lending policies and practices
- a reporting system that provides the bank with the information needed to manage the lending function and make sound credit decisions
- a well-defined lending-approval and -review system that includes established credit limits; limits and controls over the types of loans made and their minimum collateral requirements (for example, loan-to-collateral-value ratios); limits on maturities of loans; and policies on interest rates, pricing, and fee charges
- an independent loan-review function that identifies and evaluates existing and potential problem loans in a timely manner
- an independent reporting system that notifies appropriate personnel when financial information, insurance policies, or other loan documentation needs to be obtained
- a system of procedures that correct documentation exceptions

Loan administration is responsible for mitigating the operational risks associated with loan-related transactions, such as approving credit, disbursing loan proceeds, receiving loan payments, recording accrued interest and fee income, posting to subsidiary ledgers, and reconciling subsidiary and general ledgers. Typically, employees working with these types of activities have the capability to transfer funds between accounts on the bank's and the customer's behalf, which opens up an area of potential abuse. Additional potential areas for unethical employee behavior include the maintenance of loan notes and related documentation, as well as the credit and collateral files on borrowers. The bank must ensure it has adequate controls in place to avoid any improprieties; controls might include having separate departments for loan activities within a large organizational structure or rotating and/or segregating loan duties in smaller community banks. Some specific issues related to these responsibilities are described below.



## Applications and Loan-Approval Process

The bank should have written policies and procedures for obtaining and reviewing loan applications and for ensuring sufficient borrower information (both financial and collateral-related) is required and analyzed in support of the loan approval. Approvals should be made in accordance with the bank's written guidelines and should also address the disbursement of loan proceeds. Additional issues that bank policies and procedures should address include—

- the requirement that loan commitments be in writing;
- requirements for letters of credit;
- the requirement for an annual review of borrowers, including a reassessment of the appropriateness of credit lines; and
- the requirement for a process for extending or renewing loans and credit lines.

Exceptions to the bank's written policies and procedures should reflect the appropriate level of approval and should be documented in writing.

## Account Records

Bank staff should compare the approved terms for new and renewed extensions of credit (amount, maturity, interest rate, payment schedule) to the note or loan agreement for accuracy. The former should then be compared with the trial balance, if it is automated. If a manual system is used, the approved amount of the extension of credit should be checked against deposit tickets to ensure the correct amount was transferred to the borrower's account. Adjustments to loan accounts or accrued interest receivable accounts should be checked and tested by an individual independent of the loan-processing area. Subsidiary records should be routinely reconciled with the appropriate general ledger accounts.

## Payments

Regardless of the type of payment, principal, interest, or fee, certain controls are necessary to ensure the effectiveness of operations, as well as the safeguarding of bank assets. An individual who cannot originate loan entries should perform an independent test of interest, commis-

sions, and fee computations to confirm their accuracy. Payment notices should be prepared by someone other than a loan teller. In addition, loan officers should be prohibited from process-

ing loan payments. Payments received by mail, tellers, or other departments should be separate from the loan-recording function. Supervisory approvals should be required for processing payments that are less than the amount contractually due, pertain to delinquent loans, are received irregularly, or involve waiving late fees. Collection notices should also be handled by someone not associated with loan processing.

## Credit File Documentation

The bank should establish and maintain credit files for all borrowers. The bank's written loan policy should detail the minimum acceptable amount of information to be included in a borrower's credit file. The credit file should contain information on the extension of credit that identifies its purpose, source of repayment, repayment terms, and disposition of loan proceeds. Additionally, information should be on file relating to and/or analyzing the borrower's financial condition, including tax returns as appropriate; collateral, its valuation and related hazard insurance; the loan officer's contact with the borrower; and other pertinent documents, such as guarantor information, loan agreements, and loan covenant check sheets. Banks should maintain this information to support their evaluation of the borrower's creditworthiness and to leave a paper trail for auditors. The bank should also implement a file documentation tickler system to help bank personnel obtain updated information on borrowers, thereby facilitating continuous assessment and monitoring of credit risk.

## Collateral Records

Banks should maintain a register to document collateral received from and released to borrowers, which should correspond to the actual collateral being held. Negotiable collateral should be maintained under dual control in a fireproof vault. The receiving and releasing of collateral to customers should be handled by individuals other than those who make entries in the collateral register. The bank should issue a receipt to customers for each item of collateral it is holding in safekeeping. Signed customer receipts should be obtained and filed after the collateral is released.

## Management Information Systems

Management information systems, an increasingly important component of the loan administration function, allow a bank to manage its lending decisions more efficiently and effectively. Whether the bank uses a computerized or manual system to manage its loan portfolio, the following types of information should be readily available and routinely reviewed by management:

- total loans and commitments
- loans in excess of existing credit limits
- new extensions of credit, credit renewals, and restructured credits
- a listing of all delinquent and/or nonaccrual loans
- credits adversely graded or requiring special attention
- credits to insiders and their related interests
- credits not in compliance with policies, laws, or regulations
- specific lending activity aspects, including automated financial statement spreads of borrowers and analyses of the bank's credit exposure by type, geographic areas, collateral, and large employers

## INTERNAL LOAN REVIEW

The internal loan review function should not be merely an after-the-fact, loan-by-loan review, but a process to detect weaknesses in the various levels of an institution's credit approval and monitoring system.

The nature of loan review systems may vary based on an institution's size, complexity, and management practices. For example, a loan review system may include components of a traditional loan review function that is independent of the lending function. Or, it may place some reliance on loan officers. While the former method is preferred, reliance on the lending staff could be appropriate if the loan officers are not permitted sole discretion to assign credit-quality ratings. In addition, the term "loan review system" can refer to various responsibilities assigned to credit administration, loan administration, problem-loan workout, or other areas. These responsibilities may range from administering the internal problem loan-reporting process to maintaining the integrity of the credit-grading process (for example, ensuring that

changes are made in credit grades as needed) and coordinating the information necessary to assess ALLL adequacy. Regardless of the structure of the loan review function, an effective system should—

- ensure consistent application of the credit-grading system,
- promptly and accurately identify loans with potential or well-defined credit weaknesses and ensure the development and implementation of an appropriate action plan to minimize credit losses,
- project relevant trends that affect the collectibility of the portfolio and isolate potential problem areas,
- act as an information source concerning emerging trends in the portfolio and the bank's area economy,
- provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio,
- provide essential information to determine the adequacy of the ALLL,
- assess the adequacy of and adherence to internal credit policies and loan administration procedures, and monitor compliance with relevant laws and regulations,
- ensure that relevant supporting loan documentation has been obtained,
- help develop and revise lending policy and procedures,
- evaluate the activities of lending personnel, and
- provide management with accurate and timely information related to credit quality that can be used for financial and regulatory reporting purposes.

### Characteristics of Loan Review Program

To accomplish the preceding loan review objectives effectively, the program must possess the following components:

- a policy that clearly defines responsibilities of the loan review function and that communicates directorate and management support to all personnel involved in the lending function
- a policy that explicitly describes the bank's credit-grading system and grading definitions
- the capacity for objective judgment of loan quality and the autonomy to exercise it

- the freedom to communicate directly, without fear of reprisal, with senior management and the bank's board of directors
- skilled personnel who are experienced in credit analysis and knowledgeable of sound lending operations
- training and continuing education resources for the loan review staff

### Credit-Grading Systems

The foundation of any loan review system is accurate and timely credit grading (also referred to as risk rating), which involves assessing credit quality and, ultimately, identifying problem loans. An effective credit-grading system provides that the bank's risk ratings on "non-pass" credits be updated periodically (at least quarterly) so that (1) the ALLL is appropriate for the risk contained in the portfolio and (2) strategies relative to workout action plans are up-to-date. Regardless of the type of loan review system employed, an effective credit-grading framework generally places primary reliance on loan officers to identify emerging loan problems. However, given the importance and the subjective nature of credit grading, a loan officer's judgment on the assignment of a particular credit grade to a loan should be subject to review by (1) peers, superiors, or loan committees; (2) an independent, qualified part-time or full-time person(s); (3) an internal department staffed with credit review specialists; or (4) outside credit review consultants. A review of the credit-quality assessment independent of the lending function is preferred because it typically provides a more conservative and realistic assessment of credit quality. Accurate and timely credit grading is a critical component of an effective loan review system. Each institution should ensure that its loan review system includes the following attributes:

- a formal credit-grading system that can be reconciled with the framework used by the federal regulatory agencies<sup>10</sup>

10. An institution may have a credit-grading system that differs from the credit-grading framework used by the Federal Reserve. However, each institution that maintains a credit-grading system that differs from the Federal Reserve's framework should maintain documentation that translates its credit-grading system into the pass/special mention/substandard/doubtful/loss credit-grading framework used by the Federal Reserve. This documentation should be sufficient to enable

- an identification or grouping of loans that warrants the special attention of management, with documentation supporting the reasons a particular loan deserves special attention
- a mechanism for direct, periodic, and timely reporting to senior management and the board of directors on the status of loans identified as needing special attention, and the actions taken by management
- appropriate documentation of the institution's credit loss experience for various components of its loan and lease portfolio<sup>11</sup>

An institution should maintain a written description of its credit-grading system, including a discussion of the factors used to assign appropriate credit grades to loans. Loan grades should reflect the risk of credit losses. In addition, the loan review program should be in writing, and the board of directors should review and approve it at least annually to evidence its endorsement.

## Loan Review System Elements

An institution's written policy and documentation of its loan review system should address the following elements:

- qualifications of loan review personnel
- independence of loan review personnel
- frequency of reviews
- scope of reviews
- depth of reviews
- review of findings and follow-up
- workpaper and report distribution, including distribution of reports to senior management and the board of directors

*Qualifications of Loan Review Personnel*—Persons involved in the loan review function should be selected based on level of education, experience, and extent of formal credit training. They should be knowledgeable of both sound lending practices and the institution's lending guidelines for the types of loans it offers. In

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examiners to reconcile the totals for the various credit grades under the institution's system to the Federal Reserve's categories listed above.

11. Institutions are encouraged to maintain records of net credit loss experience for credits in each of the following categories: pass, special mention, substandard, doubtful, and loss.

addition, loan review personnel should be aware of relevant laws and regulations affecting lending activities.

*Independence of Loan Review Personnel*—An effective loan review system uses (1) a loan officer's initial identification of emerging problem loans and (2) the credit review of loans by individuals independent of the credit approval decisions. The first element of an effective system recognizes the loan officer's responsibility to continually analyze his or her portfolio and to promptly identify and report problem loans. Due to their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to the nonlending staff. However, banks should not rely completely on loan officers for identification of problem loans because they may not be entirely objective in assessing the borrower's credit quality. The second element of an effective loan review system recognizes that loans should be reviewed by individuals that do not have responsibility for the loans they review and that the evaluation of the credit should not be influenced by anyone associated with the loan approval/management process.

While larger institutions typically establish a separate department of credit review specialists, cost and volume considerations may not justify such a system in smaller institutions. As a result, in many smaller institutions, management, a loan committee, or even loan officers may fill this role—or it may be filled by outside consultants who periodically come to the bank and review parts or all of the loan portfolio. Whether or not the institution has an independent loan review department, the loan review function should report directly to the board of directors or a board committee. (Senior management may be responsible for appropriate administrative functions as long as the independence of the loan review function is not compromised.)

*Frequency of Reviews*—Optimally, the loan review function provides useful, continual feedback on the effectiveness of the lending process to identify any emerging problems. For example, significant credits should be reviewed at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality of a borrower or a particular type of loan or pool of loans. A system of ongoing or periodic portfolio reviews is particularly important to the ALLL

determination process, which depends on the accurate and timely identification of problem loans.

*Scope of Reviews*—The review should cover all borrowers whose exposure is significant to the size of the bank. Additionally, each review should typically include the following components of the portfolio under review: a sample of smaller loans; past-due, nonaccrual, renewed, and restructured loans; loans previously classified or designated as special mention by the institution or its examiners; insider loans; and concentrations of credit, including other loans affected by common repayment factors. It is important that the scope-related information indicates that these components have been included in the review of the portfolio and that the percentage of the portfolio selected for review provides reasonable assurance that review results identify major problems in that portion of the portfolio and accurately reflect its quality. On a larger scale, the scope of management's review of the entire loan portfolio should attest to the fact that its reviews identify problem loans significant to the bank and accurately reflect portfolio quality on an ongoing basis. The scope of loan reviews should be approved annually by the institution's board of directors or when significant changes are made to the scope.

*Depth of Reviews*—Reviews should analyze a number of important aspects of selected loans, including—

- credit quality;
- sufficiency of credit and collateral documentation;
- proper lien perfection;
- proper approval by the loan officer and loan committee(s);
- adherence to any loan-agreement covenants;
- compliance with laws, regulations, and internal policies and procedures; and
- the appropriateness and timeliness of problem-loan identification by loan officers.

*Review of Findings and Follow-Up*—Findings should be reviewed with appropriate loan officers, department managers, and members of senior management. Management's responses to all noted deficiencies and identified weaknesses should include existing or planned corrective actions and the timeframes for correction. Significant noted deficiencies and identified weak-

nesses that remain unresolved beyond the assigned correction timeframes should be promptly reported to senior management and, if still unresolved, to the board of directors.

*Workpaper and Report Distribution*—Workpapers should contain a list of the borrowers included in the scope of the review and all supporting information needed to substantiate the findings. Reports to management discussing the findings of a portfolio review should indicate the "as of" review date; address the credit grading (risk rating) of the individual borrowers (loans) reviewed, as well as of the specific portfolio; assess the adequacy of and adherence to internal policies and procedures; indicate loan, credit file, and collateral deficiencies; and evaluate compliance with laws and regulations. The reports also should include summary analyses supporting the assignment of special-mention or classified designations to borrowers (loans). A summary report to the board of directors should be submitted at least quarterly and include findings relative to the areas previously mentioned for all reviews conducted during that timeframe (more frequently if material adverse trends are noted.) This summary report might include, in addition to the issues found in the reports to management, comparative trends identifying significant changes in the overall quality of the portfolio.

## Examination Scope Guidance

An effective loan review function can greatly assist examiners in their review of the bank's loan portfolio. The examination process should evaluate the internal loan-review function by assessing the scope and depth of the review and the quality of the output. While examiners should not rely entirely on the bank's findings, they can limit the scope of their loan examination by developing a comfort level with the bank's internal loan-review function. To determine the reliability, if any, of the internal loan-review function, examiners should assess the adequacy of management's ability to identify problem loans. Two issues should be evaluated in this regard: timeliness and accuracy. The first issue deals with the ability of loan review to distinguish a problem loan and/or borrower from a nonproblem one when it initially becomes a problem. The second issue deals with the accuracy of loan review in identifying the

severity of the problem. The Extent that examiners rely on an internal loan-review function depends upon their comfort level with the bank in the aforementioned regard.

The examiner will be able to determine the degree to which the bank's loan review function can be relied upon by reviewing prior examination criticisms, as well as management's response to them, and a sufficient sample of the bank's portfolio. Whether the borrower being reviewed as a part of the sampling process is a pass or nonpass credit, examiners should consider narrowing the scope of the pass credits included in the loan examination if they concur with the bank's risk ratings. However, examiners still should continue their analysis of all "nonpass" credits due to their importance to the adequacy of the ALLL.

## NONACCRUAL LOANS

Loans and lease-financing receivables are to be placed on nonaccrual status if (1) principal or interest has been in default for 90 days or more, unless the loan is both well secured and in the process of collection; (2) payment in full of principal or interest is not expected; or (3) they are maintained on a cash basis because the financial condition of the borrower has deteriorated.

*Definition of "well secured" and "in the process of collection"*—An asset is "well secured" if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full or (2) by the guarantee of a financially responsible party. An asset is "in the process of collection" if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or (2) in appropriate circumstances, through collection efforts not involving legal action, which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future. For the purposes of applying the above third test for nonaccrual status, the date on which an asset reaches nonaccrual status is determined by its contractual terms that principal or interest has been in default for a period of 90 days or more, unless the asset is both well secured and in the process of collection. If the principal or interest

on an asset becomes due and remains unpaid for 90 days or more on a date that falls between report dates, the asset should be placed in nonaccrual status as of the date it becomes 90 days past due. It should remain in nonaccrual status until it meets the following exception criteria for restoration to accrual status described below. (Any state statute, regulation, or rule that imposes more stringent standards for nonaccrual of interest should take precedence over this instruction.)

*Exceptions*—A loan does *not* need to be placed on nonaccrual status if (1) the criteria for accrual of income under the interest method specified in Accounting Standards Council (ASC) Subtopic 310-30, Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality (formerly AICPA Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer"), are met for a purchased impaired loan or debt security accounted for in accordance with that subtopic, regardless of whether the loan or debt security had been maintained in nonaccrual status by its seller; (2) the criteria for amortization specified in AICPA Practice Bulletin No. 6 are met with respect to a loan or other debt instrument accounted for in accordance with that Practice Bulletin that was acquired at a discount from an unaffiliated third party, including those that the seller has maintained on nonaccrual status; or (3) the loan is a consumer loan or secured by a one- to four-family residential property. However, the bank may elect to carry these loans on a nonaccrual status. Also, if a bank has a significant consumer or residential mortgage loan portfolio in relation to its total loans and tier 1 capital, a thorough review of the delinquency status should be performed to ensure that the bank has not materially misstated its financial condition and earnings.

*Treatment of Cash Payments and Criteria for the Cash-Basis Treatment of Income*—When a bank places a loan on nonaccrual status, it must consider how to account for subsequent payments. When the collectibility of the remaining book balance of a loan on nonaccrual status is uncertain, any payments received must be applied to reduce the recorded investment in the asset or principal to the extent necessary to eliminate such doubt. Placing an asset on nonaccrual status does not require a charge-off, in whole or in part, of the asset's principal. How-

ever, *any identified losses* must be charged off.

When a loan is on nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis, as long as the remaining recorded balance of the asset after the charge-off, if any, is deemed fully collectible.<sup>11a</sup> A bank's determination of the collectibility of an asset's remaining book balance must be supported by a current, well-documented credit evaluation of the borrower's financial condition and repayment prospects.

When recognition of interest income on a cash basis is appropriate, the amount of income recognized should be limited to what would have been accrued on the loan's remaining book balance at the contractual rate. Any cash interest payments received over this limit (and not applied to reduce the loan's remaining book balance) should be recorded as recoveries of prior charge-offs until these charge-offs have been fully recovered. (A bank should have a well-defined policy governing the treatment of interest income and the charge-off of accrued interest receivables.)

*Treatment of Previously Accrued But Uncollected Interest*—When a bank places a loan on nonaccrual status, its policy should address an appropriate treatment of previously accrued but uncollected interest. One method is to reverse all previously accrued but uncollected interest against appropriate income and balance-sheet accounts. For interest accrued in the current accounting period, the entry is made directly against the interest income account. For prior accounting periods, if accrued-interest provisions to the ALLL were not made, the amount of accrued but uncollected interest should be charged against current earnings. Also for prior accounting periods when provisions to the ALLL for possible loss of interest had been made, the bank generally reverses the accrued but uncol-

lected interest by charging the ALLL to the extent of those specific provisions. Generally accepted accounting principles do not require the write-off of previously accrued interest if principal and interest are ultimately protected by sound collateral values. A bank is expected to have a well-defined policy, subject to examiner review, governing the write-off of accrued interest.

*Treatment of Multiple Extensions of Credit to One Borrower*—As a general rule, nonaccrual status for an asset should be determined by assessing its collectibility, repayment ability, and performance. Thus, when one loan to a borrower is placed in nonaccrual status, a bank does not automatically have to place all of that borrower's other extensions of credit in nonaccrual status. The bank should evaluate its other extensions of credit to that borrower to determine if one or more of them also should be placed in nonaccrual status.

*Restoration to Accrual Status*—As a general rule, a nonaccrual loan may be restored to accrual status when (1) its principal and interest are no longer past due and unpaid, and the bank expects repayment of the remaining principal and interest, or (2) when it otherwise becomes well secured and in the process of collection. Before restoring a loan to accrual status, the bank should consider the borrower's prospects for continuing future contractual payments. If reasonable doubt exists, reinstatement may not be appropriate.

To meet the first test, the bank must have received payment of the past-due principal and interest, unless (1) the loan has been formally restructured and qualifies for accrual status under the restructured terms; (2) the asset is a purchased impaired loan or debt security accounted for in accordance with ASC Subtopic 310-30 and it meets the criteria for accrual of income under the interest method specified therein; or (3) the asset has been acquired at a discount (due to uncertainty about the amounts or timing of future cash flows) from an unaffiliated third party and meets the amortization criteria (that is, accretion of discount) specified in AICPA Practice Bulletin No. 6 or the borrower has resumed paying contractual interest and principal payments on the loan, even if the past-due amount has not been brought fully current. These loans may be returned to accrual status provided two criteria are met: (1) all principal and interest

<sup>11a</sup>. An asset in nonaccrual status that is subject to the cost recovery method required by former AICPA Practice Bulletin No. 6 or ASC Subtopic 325-40, Investments—Other—Beneficial Interests in Securitized Financial Assets (formerly Emerging Issues Task Force Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets"), should follow that method for reporting purposes. In addition, when a purchased impaired loan or debt security that is accounted for in accordance with ASC Subtopic 310-30 has been placed on nonaccrual status, the cost recovery method should be used, when appropriate.

amounts contractually due (including arrearages) are reasonably assured of repayment within a reasonable period, and (2) the borrower has a sustained period of repayment performance (generally a minimum of six months) in accordance with the contractual terms.

Until the loan is restored to accrual status, cash payments received must be treated according to the criteria stated above. In addition, after a formal restructuring, if the loan that has been returned to accrual status later meets the criteria for placement in nonaccrual status (as a result of past-due status based on its modified terms or for any other reason), the asset must be placed on nonaccrual status.

*Treatment of Nonaccrual Loans with Partial Charge-Offs*—GAAP and regulatory reporting requirements do not explicitly address whether partial charge-offs associated with a nonaccrual loan (that has not been formally restructured) must be fully recovered before a loan can be restored to accrual status.

According to Call Report instructions, restoration to accrual status is permitted when (1) the loan has been brought fully current with respect to principal and interest and (2) the bank expects the loan's full contractual balance (including any amounts charged off), plus interest, will be fully collectible under the terms of the loan. Thus, to return a partially charged-off loan that has been brought fully current to accrual status, the bank should determine if it expects to receive the full amount of principal and interest called for by the loan's terms.

When the contractual principal and interest of a loan have been brought fully current, and the borrower's financial condition and repayment prospects have improved so that the full contractual principal (including any amounts charged off) and interest is expected to be repaid, the loan may be restored to accrual status *without* having to first recover the charge-off. Conversely, this treatment would be inappropriate when the charge-off indicates continuing doubt about the collectibility of principal or interest.

The reasons for restoring a partially charged-off loan to accrual status must be documented. These actions should be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for full repayment of contractual principal (including any amounts charged off) and interest. This

documentation will be subject to review by examiners.

*Examiner Review*—Some states have promulgated regulations or adopted policies for non-accrual of interest on delinquent loans that may differ from the above procedures. In these cases, the bank should comply with the more restrictive policy. The examiner should ensure that the bank is complying with such guidelines. In all cases, each bank should formulate its own policies to ensure that net income is not being overstated. These policies are subject to examiner review.

## RESTRUCTURED OR RENEGOTIATED "TROUBLED" DEBT

In a "troubled-debt restructuring," a bank grants a borrower concessions for economic or legal reasons related to a borrower's financial difficulties that it would not otherwise consider. Renegotiated "troubled" debt includes (1) the transfer from the borrower to the bank of real estate, receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan; (2) modification of loan terms, such as a reduction of the stated interest rate, principal, or accrued interest, or an extension of the maturity date for new debt with similar risk; or (3) a combination of the above. A loan extended or renewed at a stated rate equal to the current interest rate for new debt with similar risk is not considered renegotiated debt. For further information, see the instructions for the Reports of Condition and Income; and ASC Subtopic 310-40, Receivables—Troubled Debt Restructurings by Creditors (formerly FASB Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," as amended by FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan"). All loans whose terms have been modified in a troubled debt restructuring must be evaluated for impairment under ASC topic 310, "Receivables." Under ASC Topic 310, a measuring of impairment on a troubled loan using the present value of future cash flows should be discounted at the effective interest rate of the original loan (that is, before the restructuring).<sup>12</sup>

<sup>12</sup> FASB 118 amended FASB 114 to allow creditors to use



A bank should develop a policy for renegotiated troubled debt to ensure that such items are identified, monitored, and properly accounted for and controlled. These restructurings should occur infrequently. If not, the bank is probably experiencing significant problems. Before troubled-debt concessions are made to a borrower, it is a good practice to have the transactions receive prior approval of the board of directors or a board committee. All these transactions should be reported to the board of directors upon enactment.

Bankers may be involved in formally restructuring loans when borrowers experience financial difficulties or in light of the borrower's condition and repayment prospects.<sup>12a</sup> These actions, if consistent with prudent lending principles and supervisory practices, can improve a bank's collection prospects. GAAP and regulatory reporting requirements provide a reporting framework that may alleviate some of the lender's concerns about working constructively with borrowers experiencing financial difficulties.

The interagency policy statement on credit availability, issued March 1, 1991, clarifies a number of supervisory policies on restructured-loan issues. Two of these clarifications indicate that when certain criteria are met, (1) nonaccrual assets can be restored to accrual status when subject to formal restructurings in accordance with ASC Subtopic 310-40 and (2) restructurings that yield a market rate of interest would not have to be included in restructured loan amounts reported in the years following the restructuring. These clarifications, which are

existing methods for recognizing interest income on impaired loans. This statement also clarifies the existing accounting for in-substance foreclosure. Under the impairment standard and related amendments to FASB 15, a collateral-dependent real estate loan (that is, a loan for which repayment is expected to be provided solely by the underlying collateral) would be reported as OREO only if the lender has taken possession of the collateral. For other collateral-dependent real estate loans, loss recognition would be based on the fair value of the collateral if foreclosure is probable. However, these loans would no longer be reported as OREO. Rather, they would remain in the loan category. In light of the significance of these changes to accounting standards, the Federal Reserve is reevaluating regulatory disclosure and nonaccrual requirements and expects to issue revised policies at a later date. (See SR-93-30 (FIS).) FASB 15 is also amended by FASB statements 71, 111, 121, 141, 145, and 149. (See FASB's current text.)

12a. For further guidance on loan restructuring and work-out arrangements, refer to the Statement on Working with Mortgage Borrowers that was issued by the Federal Reserve and the other federal financial institution regulatory agencies (see SR-07-6).

consistent with GAAP, have been fully incorporated into the instructions for the Reports of Condition and Income (Call Reports).

## Restructurings

A loan or other debt instrument that has been formally restructured to ensure repayment and performance need not be maintained in non-accrual status. In deciding whether to return an asset to accruing status, payment performance that had been sustained for a reasonable time before the restructuring may be considered. For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. It may be that the amount and frequency of payments under the restructured terms do not exceed those of the payments that the borrower had made over a sustained period within a reasonable time before the restructuring. In this situation, if the lender is reasonably assured of repayment and performance according to the modified terms, the loan can be immediately restored to accrual status.

A period of sustained performance, whether before or after the date of the restructuring, is very important in determining whether there is reasonable assurance of repayment and performance. In certain circumstances, other information may be sufficient to demonstrate an improvement in the borrower's condition or in economic conditions that may affect the borrower's ability to repay. This information may reduce the need to rely on the borrower's performance to date in assessing repayment prospects. For example, if the borrower has obtained substantial and reliable sales, lease, or rental contracts or if other important developments are expected to significantly increase the borrower's cash flow and debt-service capacity and strength, then the borrower's commitment to repay may be sufficient. A preponderance of such evidence may be sufficient to warrant returning a restructured loan to accrual status. The restructured terms must reasonably ensure performance and full repayment.

It is imperative that the reasons for restoring restructured debt to accrual status be documented. A restoration should be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for repayment. This documentation will be reviewed by examiners.

The formal restructuring of a loan or other debt instrument should be undertaken in ways that will improve the likelihood that the credit will be repaid in full in accordance with reasonably restructured repayment terms. A restructured loan may not be restored to accrual status unless there is reasonable assurance of repayment and performance under its modified terms in accordance with a reasonable repayment schedule. Regulatory reporting requirements and GAAP do *not* require a banking organization that restructures a loan to grant excessive concessions, forgive principle, or take other steps not commensurate with the borrower's ability to repay to use the reporting treatment specified in ASC Subtopic 310-40 (formerly FASB Statement No. 15). Furthermore, the restructured terms may include prudent contingent payment provisions that permit an institution to obtain appropriate recovery of concessions granted in the restructuring, if the borrower's condition substantially improves.

Moreover, while restructured debt that qualifies for accrual status and yields a market rate of interest must be disclosed as a troubled debt in the year of the restructuring, it need not be disclosed in subsequent years.

### Reporting Guidance on Loan Fees and Interest

The accounting standards for nonrefundable fees and costs associated with lending, committing to lend, and purchasing a loan or group of loans are set forth in ASC Subtopic 310-20, *Receivables—Nonrefundable Fees and Other Costs* (formerly FASB Statement No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases"). In general, this statement says loan-origination fees should be deferred and recognized over the life of the related loan as an adjustment of yield. The statement applies to all types of loans, as well as to debt securities (but not to loans or securities carried at fair value if the changes in fair value are included in earnings), and to all types of lenders. For further information, see the instructions for preparing the Call Report.

### PROBLEM ASSET DISPOSAL THROUGH EXCHANGES

Financial institutions explore strategies to dispose of or reduce nonperforming assets and other real estate owned (OREO). Some of these strategies include so-called "asset exchanges," whereby third parties or marketing agents have offered to purchase problem assets from institutions and replace them with performing assets. Such transactions, if properly executed with reputable counterparties and when they are subjected to the appropriate level of due diligence, may achieve the objective of reducing nonperforming assets on financial institutions' balance sheets. Other less structured transactions may present significant risk to institutions and could compromise their safety and soundness.

The guidance in this section highlights the potential risks associated specifically with transactions which may reduce problem assets in the short term, but where a lack of appropriate, up-front due diligence may result in heightened risks over the longer term. In addition, inappropriate assumptions used in determining the fair value of the purchased assets may result in institutions being required to recognize losses shortly after inception of the transaction.

Third parties or marketing agents may offer to purchase problem assets from institutions and replace them with performing assets to help institutions diversify their loan portfolios. Institutions may perceive that asset exchange transactions offer the potential to increase interest income, reduce the level of real estate concentrations, enhance liquidity, and reduce the stress on capital. Nevertheless, these transactions may pose significant risks. Sellers could be exchanging problem assets for purportedly performing assets (acquired assets) that were recorded at values in excess of fair value. See SR-11-15.

### Risk-Management Considerations

Asset exchanges may expose institutions to significant risks, which management should assess before entering into such transactions. Management should focus not only on the immediate or short-term benefits of a transaction, but should determine its long-term effect on the institution's balance sheet and loss exposure. Management should also determine how these

risks align with the institution's overall risk-management strategy.

In undertaking due diligence on these types of transactions, management should assess the risks and provide evidence of its analysis, taking into account—

- the reported benefits to the institution from the transfer. This assessment should address whether the transaction would actually enable the institution to transfer significant risk associated with the problem assets.
- the economic costs and benefits of the transaction. This should include the economic benefits accruing to the marketing agent; the marketing agent's responsibilities and liabilities; and the loss position, including recourse, of each participant if either the ceded assets or acquired assets do not perform as anticipated.
- the servicing responsibilities attached to the acquired assets. If the institution assumes servicing responsibilities for the acquired assets, the institution should evaluate and show evidence that it has the capacity and infrastructure in place, as well as appropriate risk controls, to service the acquired assets.
- the transaction's compliance with the risk-tolerance and risk-mitigation policies established by the institution's board of directors, including the overall strategy for managing or reducing problem assets.
- the appropriate accounting treatment in accordance with U.S. generally accepted accounting principles (GAAP). Specific issues with regard to the appropriate accounting treatment include, but are not limited to, the following:
  - When specific loans are identified for inclusion in exchange transactions and the institution decides to sell the loans, they should be transferred to a "held-for-sale" account at the lower of cost or fair value with losses recognized through earnings. Any reduction in value should be reflected as a write-down of the recorded investment resulting in a new cost basis. The sale of these loans should occur at an appropriate fair value.
  - Newly acquired assets should be recorded at an appropriate fair value.
- a review of the marketing agent. This should include, but not be limited to, an assessment of the agent's financial strength, including its ability to provide credit enhancement if it is required in the transaction.
- the relationship between the marketing agent

and any entity providing services for the transaction, with particular attention paid to possible cross-ownership or other related-party relationships.

- an independent valuation by a reputable and experienced third-party valuation expert of the assets being acquired. The party that performs the valuation should be independent of the marketing agent and the institution selling the performing assets. The use of outside resources does not relieve management of its responsibility to ensure that fair-value estimates are measured in accordance with GAAP.<sup>12b</sup> Management should sufficiently understand the bases for the measurement and valuation techniques used by outside parties to determine the appropriateness of these techniques, the underlying inputs and assumptions, and the resulting fair-value measurements.<sup>12c</sup>
- the acquiring institution's experience, skills, personnel, and risk-management capabilities to manage the newly acquired assets, especially if the assets are in business segments or geographical areas that are different from the institution's own.

## Supervisory Responsibilities

It is not necessary to scope a specific review of these transactions into routine examination activities, particularly when there is no evidence that a bank has engaged in such transactions. Reserve Banks nevertheless should be aware of indications of possible asset exchange transactions as part of their routine monitoring of financial institutions between examinations. Examiners should hold ongoing discussions with an institution's management as part of the supervision process if examiners become aware that the institution is considering these types of transactions. Monitoring activities should focus on financial statement changes commonly associated with asset exchanges, internal risk-management reports, and other documents received on a routine basis. Indicators that asset

<sup>12b</sup>. Fair-value measurements are determined based on assumptions that market participants would use in valuing the assets. This should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows.

<sup>12c</sup>. Examples of significant inputs and assumptions include, but are not limited to, default probabilities, current loan-to-value ratios, loss severities, and prepayment speeds.

exchanges might have taken place include—

- asset sales at (or very near) book values, with either no loss recognized or a gain on recovery of a prior write-down recognized. It is unusual for a third party to buy problem assets at higher than the selling institution's book value at the time of the sale.
- board minutes showing discussion of strategies designed to achieve material reductions in problem assets.
- material loan sales and purchases involving the same counterparty, on or around the same date.
- significant reductions in the institution's non-performing loan totals without attendant losses. The motivation for asset exchanges is to reduce problem assets, but this may be difficult to do in the current economic environment without realizing significant losses.
- purchase of a large portfolio of loans that are outside the institution's traditional markets and/or are inconsistent with the institution's business strategies or lending and investment policies.
- purchase at (or near) par of a large portfolio of loans that, while currently performing, have high-risk characteristics (e.g., are outside generally accepted underwriting standards for this type of credit) that indicate they may not continue to perform in accordance with their contractual terms.
- large net loan or asset growth during a short period. Because asset exchanges nearly always involve an institution purchasing more assets than it is selling, it is common for the balance sheet to grow rapidly as a result of the asset exchange transaction.

## Supervisory Actions

If examiners observe an institution engaging in asset exchanges, they should determine whether the appropriate risk-management measures have been considered and if management has used appropriate valuations in accordance with GAAP. Important findings should be noted in the examination report and, as appropriate, plans for remedial action discussed with management. Given the concern regarding both safety-and-soundness issues as well as the appropriate valuation practices, Reserve Banks should contact the appropriate Board staff analyst to discuss the asset exchange transaction.

## TRANSFER OF LOW-QUALITY LOANS OR OTHER ASSETS

Section 23A of the Federal Reserve Act (FRA), 12 USC 371c, prohibits bank purchases of low-quality assets from an affiliate. In addition to the statutory provisions of section 23A, the Board approved the issuance of Regulation W, which became effective April 1, 2003, implementing changes to sections 23A and 23B of the FRA.

Low-quality loans include those classified or specially mentioned at the most recent examination or loans that would most likely be classified or specially mentioned if subjected to a review. In addition, low-quality loans include 30-day past-due loans, nonaccrual loans, loans on which the terms have been renegotiated because of a borrower's poor financial condition, and any other loans the examiner believes are questionable. Other assets of questionable quality include depreciated or subinvestment-grade securities and other real estate. A low-quality asset shall not be acceptable as collateral for a loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of an affiliate. Furthermore, a low-quality asset cannot be involved in a loan participation or an asset swap.

The transfer of low-quality loans or other assets from one depository institution to another may raise supervisory concerns. These transfers may be made to avoid detection and classification during regulatory examinations and may be accomplished through participation, purchases/sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Examiners should be alert to situations in which an institution's intention appears to be concealing low-quality assets to avoid examiners' scrutiny and possible classification.

During bank examinations, examiners are requested to identify situations when low-quality assets have been transferred between the institution being examined and another depository institution. The transfer of assets to avoid supervisory review is a highly improper and unsound banking practice and, if an affiliate is involved, is a violation of section 23A of the Federal Reserve Act. If necessary, it should be addressed through formal supervisory enforcement action.

Any transfers of low-quality or questionable assets should be brought to the attention of

Reserve Bank supervisory personnel. In turn, these individuals should notify the local offices of primary federal and state regulators (if applicable) of the other depository institutions involved in the transaction. For example, Reserve Banks should notify the primary federal and state regulators (if applicable) of any depository institution to which a state member bank or holding company is transferring or has transferred low-quality loans. Reserve Banks should also notify the primary federal and state regulators (if applicable) of any depository institution from which a state member bank or holding company is acquiring or has acquired low-quality loans. This procedure applies to transfers involving savings and loan associations, savings banks, and commercial banking organizations.

If the examiner determines a permissible transfer of assets was undertaken, he or she should ensure the assets have been properly recorded at fair market value on the books of the acquiring institution. If the transfer involved the parent holding company or a nonbank affiliate, the examiner should determine if the transaction also was recorded properly on the affiliate's books.<sup>13</sup>

Whenever asset transfers occur, examiners should determine whether the assets in question were independently and completely evaluated for conformance with bank policy and procedures. Examiners should be guided by the inspection procedures outlined in section 2020.7.2 of the *Bank Holding Company Supervision Manual* and the examination procedures in section 4050.3 of this manual.

## ENVIRONMENTAL LIABILITY

Banks may be liable for cleaning up hazardous substance contamination under both federal and state environmental liability statutes. This liability can arise through a bank's ownership or acquisition of real estate, in its role as a creditor, or in a fiduciary role. Banks may also be exposed to environmental liability indirectly through the increased possibility that a borrower's creditworthiness may be impaired by a liability to pay for cleanup of contaminated property, even if the property does not secure bank debt.

The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), the

federal superfund statute, authorizes the Environmental Protection Agency (EPA) to clean up hazardous waste sites and to recover costs associated with the cleanup from entities specified in the statute. While the superfund statute is the primary federal law dealing with hazardous substance contamination, numerous other federal and state statutes establish environmental liability that could place banks at risk.

CERCLA defines who is subject to liability for the costs of cleaning up hazardous substance contamination. The definition includes "... the owner and operator of a vessel or a facility, (or) any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of..."<sup>14</sup> Under the statute, a person or entity that transports or arranges to transport hazardous substances can also be held liable for cleaning up contamination.

The superfund statute imposes a standard of strict liability, which means the government does not have to prove that the owners or operators knew about or caused the hazardous substance contamination in order for them to be liable for the cleanup costs. Moreover, liability under the statute is joint and several, which allows the government to seek recovery of the entire cost from any individual party that is liable for those costs under CERCLA.

CERCLA provides an exemption for secured creditors in the definition of "owner and operator" by stating that these terms do not include "... a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility."<sup>15</sup> However, this exception has not provided banks with an effective defense from liability because courts have limited its applicability. Specifically, courts have held that some lenders' actions to protect their security interests have resulted in the bank "participating in the management of a vessel or facility," thereby voiding the exemption. Additionally, once the title to a foreclosed property passes to the bank, some courts have held that the exemption no longer applies and that the bank is liable under the superfund statute as an "owner" of the property. Under some circumstances, CERCLA may exempt landowners who acquire property without knowing about existing conditions (the "innocent landowner

13. See SR-83-24 (FIS).

14. CERCLA, section 107(a).

15. CERCLA, section 101(20)(A).



defense”). However, the courts have applied a stringent standard to qualify for this defense. Since the statute provides little guidance as to what constitutes the appropriate timing and degree of due diligence to successfully employ this exemption, banks should exercise caution before relying on it.

## Overview of Environmental Hazards

Environmental risk can be characterized as adverse consequences that result from generating or handling hazardous substances or from being associated with the aftermath of contamination.

Hazardous substance contamination is most often associated with industrial or manufacturing processes that involve chemicals as ingredients or waste products. For years, these types of hazardous substances were frequently disposed of in landfills or dumped on industrial sites. However, hazardous substances are also found in many other lines of business. The following examples demonstrate the diverse sources of hazardous substances, but by no means cover them all:

- farmers and ranchers (fuel, fertilizers, herbicides, insecticides, and feedlot runoff)
- dry cleaners (various cleaning solvents)
- service station and convenience store operators (underground storage tanks)
- fertilizer and chemical dealers and applicators (storage and transportation of chemicals)
- lawn care businesses (application of lawn chemicals)
- trucking firms (transportation of substances such as fuel or chemicals)

Environmental liability has had the greatest impact on the real estate industry. Not only has land itself been contaminated with toxic substances, construction methods for projects such as commercial buildings have used materials that have been subsequently determined to be hazardous—resulting in significant declines in project values. For example, asbestos was commonly used in commercial construction from the 1950s to the late 1970s. Asbestos has since been found to be a health hazard and now, in many cases, must be removed or its effects abated by enclosing or otherwise sealing off the contaminated areas.

Another common source of hazardous substance contamination is underground storage tanks. Leaks from these tanks not only contaminate the surrounding ground, but often flow into ground water and travel a significant distance from the original contamination site. As contamination spreads to other sites, cleanup costs escalate.

*Effect on Banks*—A bank may encounter losses from environmental liability through direct ownership, lending and trust activities, or mergers or acquisitions of borrowers. The greatest risk to a bank is the possibility of being held solely liable for costly environmental cleanups. Under the doctrine of joint and several liability, a bank may find itself solely responsible for cleaning up a contaminated site at a cost that exceeds any outstanding loan balance or property value.

### *Direct Ownership*

A bank may be held liable for the cleanup of hazardous substance contamination in situations when it—

- takes title to property through foreclosure or acquires property to satisfy debts previously contracted;
- owns or acquires for future expansion premises that have been contaminated by hazardous substances; or
- owns, acquires, or merges with another entity involved in activities that might result in a finding of environmental liability.

*Lending Activity*—While real estate loans present the greatest risk, almost any type of loan, unsecured or secured, can expose a bank to the effects of environmental liability. A borrower who is required to pay for the cleanup of a contaminated property may be unable to provide the necessary funds both to remove contaminated materials and to service the debt. Even if the bank does not have a security interest in the borrower’s real estate, it must be aware that significant cleanup costs could threaten the borrower’s solvency and net worth (and jeopardize the collection of working-capital or equipment loans). If the loan is secured by the contaminated real estate, the bank may find that the property value has declined dramatically, depending on the degree of contamination. In determining whether to foreclose, the bank must compare the estimated cleanup costs against the

value of the collateral. In many cases, this estimated cost has been well in excess of the outstanding loan balance, and the bank has elected to abandon its security interest in the property and charge off the loan. This situation occurs because some courts have not allowed banks that have foreclosed on a property to avail themselves of the secured-creditor exemption. These rulings have been based on a strict reading of the superfund statute that provides the exemption to “security interests” only.

A bank may also expose itself to environmental liability in its role as a secured or unsecured creditor if it involves bank personnel or contractors engaged by the bank in day-to-day management of the facility or takes actions designed to make the contaminated property salable, possibly resulting in further contamination.

*Bank Premises*—Banks may also be exposed to environmental liability for property held as bank premises. A review of historical uses of properties to be acquired for relocation or future expansion should provide insight into the likelihood that contamination may have occurred and whether additional steps may be warranted.

*Mergers and Acquisitions of Borrowers*—Borrowers may face environmental risk through the activities of subsidiaries or by merging with or acquiring other companies whose activities result in environmental liability. Some courts have held that for the purposes of determining liability under the superfund statute, the corporate veil may not protect parent companies that participate in the day-to-day operations of their subsidiaries from environmental liability and court-imposed cleanup costs. Additionally, borrowers and, ultimately, banks can be held liable for contamination that occurred before they owned or used the real estate.

### *Protection Against Environmental Liability*

Banks may avoid or mitigate potential environmental liability by having sound policies and procedures designed to identify, assess, and control environmental liability. The following discussion briefly describes methods that banks may employ to minimize potential environmental liability.

Loan policies and procedures should address methods for identifying potential environmental

problems relating to credit requests. The loan policy should describe an appropriate degree of due diligence investigation required for credit requests. Borrowers in high-risk industries or localities should be investigated more stringently than borrowers in low-risk industries or localities.

After a loan is granted, periodic credit analysis of the borrower’s ability to repay should include an assessment of environmental risk. If the credit is secured by real property collateral, the bank should remain aware of the property’s uses and the potential environmental risk associated with those uses. Even if the credit is not secured by real property, periodic credit reviews should determine whether repayment prospects may be jeopardized by any activities that might expose the borrower to environmental liability.

The first step in identifying environmental risk is an environmental review. These reviews may be performed by loan officers or others. They typically identify past uses of the property; evaluate regulatory compliance, if applicable; and identify potential problems. The reviewer should interview persons familiar with present and past uses of the facility and property, review relevant records and documents, and inspect the site.

When the environmental review reveals possible hazardous substance contamination, an environmental assessment or audit may be required. Environmental assessments are made by personnel trained in identifying potential environmental hazards and provide a more thorough inspection of the facility and property. Environmental audits differ markedly from environmental assessments because independent environmental engineers are employed to investigate the property in great detail. Engineers test for hazardous substance contamination, which might require collecting and analyzing air samples, surface soil samples, or subsurface soil samples or drilling wells to sample ground water.

Other measures some banks use to help identify and minimize environmental liability to the bank include obtaining indemnities from borrowers for any cleanup costs incurred by the bank and writing affirmative covenants into loan agreements (and attendant default provisions) that require the borrower to comply with all applicable environmental regulations. Although these measures may provide some aid in identifying and minimizing potential environmental

liability, their effectiveness depends on the financial strength of the borrower and does not represent a substitute for environmental reviews, assessments, and audits.

Banks must be careful that any policies and procedures undertaken to assess and control environmental liability cannot be construed as taking an active role in the management or day-to-day operations of the borrower's business. Some activities that courts could consider active participation in the management of the borrower's business and that could subject the bank to potential liability include—

- having bank employees serve as members of the borrower's board of directors or actively participate in board decisions,
- assisting in day-to-day management and operating decisions, and
- actively determining management changes.

These considerations are especially important when the bank is actively involved in loan workouts or debt restructuring.

## LOAN PROBLEMS

The failure of directors to establish a sound lending policy, require management to establish adequate written procedures, and monitor and administer the lending function within established guidelines has resulted in substantial problems for many institutions. Loan problems may be caused by a number of factors affecting the bank or its borrowers. For a discussion of the indicators of troubled commercial real estate loans, see the 2090 sections of this manual. The major sources and causes of problem credits are explained below.

*Competition*—Competition among banks for size and community influence may result in compromising credit principles and making or acquiring unsound loans. The ultimate cost of unsound loans always outweighs temporary gains in growth and influence.

*Complacency*—The following items manifest complacency and should always be guarded against:

- lack of adequate supervision of long-term and familiar borrowers
- dependence on oral information the borrower

furnished in lieu of reliable and verifiable financial data

- optimistic interpretation of known credit weaknesses based on past survival of recurrent hazards and distress
- ignorance or disregard of warning signs about the borrower, economy, region, industry, or other related factors

*Compromise of credit principles.* For various reasons, bank management may grant loans carrying undue risks or unsatisfactory terms, with full knowledge of the violation of sound credit principles. The reasons management may compromise basic credit principles include timidity in dealing with individuals with dominating personalities or influential connections, friendships, or personal conflicts of interest. Self-dealing, salary incentives, and bonuses based on loan portfolio growth, as well as competitive pressures, may also lead to a compromise of credit principles.

*Failure to obtain or enforce repayment agreements.* Loans granted without a clear repayment agreement are, at the very least, a departure from fundamental banking principles. These loans are likely to become significant problems. A more common problem, but just as undesirable, occurs when the bank and borrower agree on repayment or progressive liquidation of a loan, but the bank fails to collect the principal payments when and how it should. A study of loan losses will show that, in many cases, amortization never equaled the principal payments the borrower agreed to make. Good lending and good borrowing both require consistent liquidation.

*Incomplete credit information.* Complete credit information is necessary to make a reasonable and accurate determination of a borrower's financial condition and repayment capacity. Adequate and comparative financial statements, operating statements, and other pertinent statistical data should be available. Other essential information, such as the purpose of the borrowing and the intended plan and repayment source, progress reports, inspections, and memoranda of outside information and loan conferences, should be contained in the bank's credit files. The lack of adequate credit information can limit management's ability to react quickly and effectively when problems develop.



*Lack of supervision.* Many loans that are sound at their inception develop into problems and losses because of ineffective supervision. This lack of supervision usually results from a lack of knowledge about the borrower's affairs over the lifetime of the loan.

*Overlending.* In one sense, overlending could come under the heading of technical incompetence. However, overlending is a weakness found in some lenders that are otherwise competent. Loans beyond the borrower's reasonable capacity to repay are unsound. Nowhere are technical competence and credit judgment more important than in determining a sound borrower's safe, maximum loan level.

*Poor selection of risks.* When banks are willing to assume more-than-normal risk levels, they often experience serious loan problems. The following general loan types may fall within the category of poor risk selection:

- loans in which the bank advances an excessive proportion of the required capital relative to the borrower's equity investment
- loans based more on the expectation of successfully completing a business transaction than on the existing net worth and repayment capacity
- loans for the speculative purchase of securities or goods
- loans collateralized by marketable assets carried without adequate margins of security
- loans made for other benefits, such as control of large deposit balances in the bank, instead of sound net worth, collateral, or repayment capacity
- loans secured solely by the nonmarketable stock of a local corporation, made in conjunction with loans directly to that corporation (The bank may consider itself forced to finance the corporation far beyond warranted limits to avoid loss on a loan that relies on the corporation's stock.)
- loans predicated on collateral of uncertain liquidation value (A moderate amount of these loans, when recognized by bank management as subject to inherent weakness, may cause few problems. However, the bank can encounter trouble if this practice becomes the rule.)

*Revenue-driven lending.* The loan portfolio is usually a bank's most important revenue-producing asset. The earnings factor, however,

must never compromise sound credit judgment and allow credits carrying undue risks or unsatisfactory repayment terms to be granted. Unsound loans usually cost far more than the revenue they produce.

*Self-Dealing.* Self-dealing is found in many serious problem banks. Self-dealing often takes the form of an overextension of credit on an unsound basis to directors or principal shareholders, or to their related interests, who have improperly used their positions to obtain funds in the form of unjustified loans (or sometimes as fees, salaries, or payments for goods or services). Officers, who hold their positions at the pleasure of the board, may be pressured to approve loan requests by insiders that, coming from customers, would have been rejected. In that situation, management may attempt to defend unsound loans or other self-dealing practices by bank insiders.

*Technical incompetence.* All able and experienced bankers should possess the technical ability to analyze financial statements and to obtain and evaluate other credit information. When this ability is absent, unwarranted losses are certain to develop. Credit incompetence of management should be discussed promptly with the board of directors.

## REGULATION O

The Federal Reserve's Regulation O (12 CFR 215) governs any extension of credit, including overdrafts, by a member bank to an executive officer, director, or principal shareholder of (1) the member bank, (2) a bank holding company of which the member bank is a subsidiary, and (3) any other subsidiary of that bank holding company. The regulation also applies to any extension of credit by a member bank to (1) a company controlled by such a person and (2) a political or campaign committee that benefits or is controlled by such a person. Regulation O also implements the reporting requirements for credit extensions by a member bank to its executive officers, directors, or principal shareholders or to the related interests of such persons (insiders).

Business transactions between a member bank and insiders require close supervisory review. Most of these transactions are soundly struc-

tured and have a legitimate business purpose so that all parties are treated equitably. However, absent the protection of an arm's-length transaction, the potential for or appearance of abuse is greater and requires intensified regulatory review. Examiners should pay close attention to all credit extensions of a member bank to its insiders and their related interests. The terms of the credit, particularly interest-rate and collateral terms, may not be preferential, and the credit may not involve more than a normal repayment risk. Examiners must also ensure that the amount of credit extended to an insider or a related interest, both to a single borrower and in the aggregate, conforms to the provisions of Regulation O.

A member bank's extension of credit may be considered abusive or self-serving if its terms are unfavorable to the lender or if the credit would not have been extended on the same terms absent the official relationship. That is, it would be improbable that each party to the credit would have entered into the credit transaction under the same terms if the relationship did not exist. When a transaction appears questionable, a complete inquiry into the facts and circumstances should be undertaken so that a legal determination can be obtained. If credit extensions appear to circumvent the intent of Regulation O, they should be identified and discussed with management and disclosed in the examination report for follow-up review and possible formal corrective action by regulatory authorities. (See Regulation O for further details.)

### Insider Use of a Bank-Owned Credit Card

Board staff issued a May 22, 2006, legal opinion in response to an FDIC request for clarification on the application of the Board's Regulation O (12 CFR 215) to credit cards that are issued to bank insiders for the bank's business purposes. The FDIC asked whether, and under what circumstances, an insider's use of a bank-owned credit card would be deemed an extension of credit by the bank to the insider for purposes of Regulation O.

The FDIC indicated that insiders of a bank often use a bank-owned credit card to purchase goods and services for the bank's business purposes. A bank-owned credit card is a credit card that is issued by a third-party financial

institution to a bank to enable the bank (through its employees) to finance the purchase of goods and services for the bank's business. Board staff commented that it was understood that (1) a bank that provides a bank-owned credit card to its employees typically forbids or discourages use of the card by employees for their personal purposes and that an employee who uses the card for personal purposes is obligated to promptly reimburse the bank and (2) a bank is liable to the card-issuing institution for all extensions of credit made under the card (whether for the bank's business purposes or for an employee's personal purposes).<sup>15a</sup>

Although section 215.3(a) of Regulation O broadly defines an extension of credit broadly to include "a making or renewal of a loan, a granting of a line of credit, or an extending of credit in any manner whatsoever," the rule also provides several important exceptions to the definition that are relevant to the FDIC's inquiry. Section 215.3(b)(1) of Regulation O excludes from the definition of extension of credit any advance by a bank to an insider for the payment of authorized or other expenses incurred or to be incurred on behalf of the bank. Also, section 215.3(b)(5) of Regulation O excludes from the definition of extension of credit indebtedness of up to \$15,000 incurred by an insider with a bank under an ordinary credit card.

Considering the provisions of Regulation O and the purposes of the insider lending restrictions in the Federal Reserve Act, Board legal staff opined that a bank does not make an extension of credit to an insider for purposes of Regulation O at the time of issuance of a bank-owned credit card to the insider (regardless of whether the line of credit associated with the card is greater than \$15,000). The opinion states also that a bank does not extend credit to an insider for the purposes of Regulation O when the insider uses the card to purchase goods or services for the bank's business purposes. However, when an insider uses the card to purchase goods or services for the insider's personal purposes, the bank may be making an extension of credit to the insider. The opinion states that an extension of credit would occur for the purposes

15a. In the responding letter, Board legal staff notes that it was understood that some banks directly issue credit cards to their employees to enable the employees to finance the purchase of goods and services for the bank's business (bank-issued credit cards). Also, the letter states that the principles set forth with regard to bank-owned credit cards also would apply to bank-issued credit cards.

of Regulation O if—and to the extent that—the amount of outstanding personal charges made to the card, when aggregated with all other indebtedness of the insider that qualifies for the credit card exception in section 215.3(b)(5) of Regulation O, exceeds \$15,000.

The FDIC also asked whether incidental personal expenses charged by an insider to a bank-owned credit card are per se violations of the market-terms requirement in section 215.4(a) of Regulation O because non-insiders do not have access to this form of credit from the bank. In response, Board staff stated that section 215.4(a) requires extensions of credit by a bank to its insiders to (1) be on substantially the same terms (including interest rates and collateral) as, and subject to credit underwriting standards that are not less stringent than, those prevailing at the time for comparable transactions with non-insiders and (2) not involve more than the normal risk of repayment or other features unfavorable to the bank.

The opinion states that a bank may be able to satisfy the market-terms requirement, however, if the bank approves an insider for use of a bank-owned credit card only if (1) the insider meets the bank's normal credit underwriting standards and (2) the card does not have preferential terms (or the card does not have preferential terms in connection with uses of the card for personal purposes). Nonetheless, use of a bank-owned credit card by an insider for personal purposes may violate the market-terms requirement of Regulation O if the card carries a lower interest rate or permits a longer repayment period than comparable consumer credit offered by the bank.

The Board staff's legal opinion applies only to the specific issues and circumstances described in the letter and does not address any other issues or circumstances.

## EXAMINATION OF THE LENDING FUNCTION

Banks are expected to clearly delineate their lending objectives, policies, and procedures in writing. Lending practices are then expected to adhere to policies and procedures, with exceptions properly justified and documented. The complexity and scope of a bank's lending policy and procedures should be appropriate to the bank's size and the nature of its activities, and

they should be consistent with prudent banking practices and relevant regulatory requirements.

Historically, examiners have primarily identified loan-portfolio-management concerns through a detailed review of credits and credit documentation. This approach remains valid, but it must be combined with a full evaluation of a bank's

lending objectives, policy, and procedures. Therefore, the scope of each examination should encompass a review of the bank's lending policy and procedures and an assessment of how lending practices adhere to the policy and procedures.

When conducting a review of loan portfolio management, examiners should pay particular attention to management's approach to and handling of the following:

- monitoring of lending practices by individual lending officers
- identification of concentrations of credit
- documentation of credit and collateral exceptions
- identification of problem credits
- accounting for nonaccrual loans and for renegotiated and restructured loans
- collection of past-due loans

In addition, examiners should be aware of any evidence of self-dealing in lending transactions.

An examiner's final assessment of a bank's lending function should consider the adequacy of internal policy and procedures, the effectiveness of management oversight and control, and the overall quality of the loan portfolio. Moreover, consideration should be given to all pertinent internal and external factors, including the continuity of management; bank's historical lending experience; and current and projected economic condition for the bank's market area, particularly for any industries in which the bank has concentrations of credit.

Supervisors and examiners should watch for indications of insufficiently rigorous risk assessment. In particular, examiners should be alert to circumstances indicating excessive reliance on strong economic conditions and robust financial markets, such as (1) borrowers whose financial capacity is inadequate to service their debts or (2) inadequate stress testing. Examiners also should be attentive when reviewing an institution's assessment and monitoring of credit risk to ensure that undue reliance on favorable conditions does not lead the institution to delay recognition of emerging weaknesses in some loans.<sup>16</sup>

If examiners observe significant and undue

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16. Examiners should recognize that an increase in classified or special-mention loans is not per se an indication of lax lending standards. Examiners should review and consider the nature of such increases and surrounding circumstances as they reach their conclusions about the asset quality and risk management of an institution.

reliance on favorable assumptions about borrowers or the economy and about financial markets more generally—or observe that this reliance has slowed the institution's recognition of loan problems—they should carefully consider downgrading, under the applicable supervisory rating framework, an institution's risk-management, management, or asset-quality ratings (or all three). If those assumptions are deemed sufficiently significant to the institution, examiners should also consider downgrading its capital adequacy rating. Similarly, if supervisors or examiners find that loan-review activities or other internal-control and risk-management processes have been weakened by staff turnover, failure to commit sufficient resources, or inadequate training, such findings should be considered in supervisory ratings as well.

When developing their findings, examiners should review internal risk-management loan-review systems, conduct sufficient loan reviews, and perform transaction testing of the lending function to determine accurately the quality of bank loan portfolios and other credit exposures. If deficiencies in lending practices or credit discipline are indicated as a result of the pre-examination risk assessment or of performing the examination, sufficient supervisory resources should be committed to in-depth reviews, including transaction testing. Adequate, in-depth reviews and transaction testing should be performed to ensure that the Reserve Bank achieves a full understanding of the nature, scope, and implications of the deficiencies.

Important findings should be noted in the examination or report. Plans for remedial actions should be discussed with bank management and the boards of directors, as appropriate. In addition, any identified weaknesses or deficiencies that could adversely affect affiliated insured depository institutions should be conveyed to the insured institution's primary federal or state supervisor.

## MORTGAGE BANKING

### Loan-Brokerage and -Servicing Activities

Loan-brokerage and -servicing activities are undertaken by mortgage banking enterprises and the mortgage banking operations of commercial banks. Mortgage banking activities consist pri-

marily of two separate but related activities: (1) the origination or acquisition of mortgage loans and the sale of the loans to permanent investors and/or (2) the subsequent long-term servicing of the loans. A mortgage banking enterprise usually retains the right to service mortgage loans it sells to permanent investors. An enterprise's right to service mortgage loans other than its own is an intangible asset that may be acquired separately. The rights to service mortgage loans are purchased and sold frequently. Mortgage loans are acquired to sell to permanent investors from a variety of sources, including applications received directly from borrowers (in-house originations), purchases from brokers, purchases from investors, and conversions of various forms of interim financing to permanent financing. A service fee, usually based on a percentage of the outstanding principal balance of the mortgage loan, is received for performing loan-administration functions. When servicing fees exceed the cost of performing servicing functions, the existing contractual right to service mortgage loans has economic value.

A number of bank services may result in assets and liabilities that do not have to be entered on the general ledger. These services are considered off-balance-sheet activities and may include the origination, sale, and servicing of various loans. Servicing and accounting activities cover functions related to initially recording the loan, collecting and recording payments, and reporting loan transactions and balances (including reporting past-due loans). Unlike the other activities in this section, servicing and accounting activities are not directly related to credit risk. However, some aspects of accounting and servicing activities, such as the accounting system's ability to produce accurate past-due loan reports, indirectly contribute to controlling credit risk. Also, poorly designed or ineffective servicing and accounting activities can contribute to increased risk in areas besides credit, such as fraud and insider abuse.

The origination, sale, and servicing of various types of loans usually have been associated with mortgage loans. But increasingly, origination and servicing activity has also been observed in government-guaranteed loans (or portions thereof), consumer loans, and commercial loans. Improper management and control of these activities by the servicer presents certain supervisory concerns. If the bank servicer is continually originating additional loans to be serviced,

the bank may find itself responsible for servicing more loans than it can prudently manage. Failure to properly administer loans may lead to legal or financial liabilities that could adversely affect the bank's capital.

## Accounting Guidance

The following accounting pronouncements issued by the Financial Accounting Standards Board (FASB) apply to mortgage banking activities:

- FAS 5, Accounting for Contingencies
- FAS 65, Accounting for Certain Mortgage Banking Activities
- FAS 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
- FAS 115, Accounting for Certain Investments in Debt and Equity Securities (paragraph 7 was amended by FAS 140)
- FAS 133, Accounting for Derivative Instruments and Hedging Activities (amended by FAS 140)
- FAS 134, Accounting for Mortgage-Backed Securities Retained After the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise
- FAS 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities
- FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- FAS 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities
- FAS 154, Accounting Changes and Error Corrections

The accounting standards for nonrefundable fees and costs associated with lending, committing to lend, and purchasing a loan or group of loans are set forth in FASB Statement No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases," (FAS 91). A summary of the statement follows. The statement applies to all types of loans as well as to debt securities (but not to loans or debt securities carried at market value if the changes in market value are included in earnings) and all types of lenders.

Nonrefundable loan fees paid by the borrower to the lender may have many different names, such as origination fees, points, placement fees, commitment fees, application fees, management fees, restructuring fees, and syndication fees. FAS 91 applies to both a lender and a purchaser and should be applied to individual loan contracts. Aggregation of similar loans for purposes of recognizing net fees or costs, purchase premiums, or discounts is permitted under certain circumstances specified in FAS 91, or if the result does not differ materially from the amount that would have been recognized on an individual loan-by-loan basis. In general, FAS 91 specifies the following:

- Loan-origination fees should be deferred and recognized over the life of the related loan as an adjustment of yield (interest income). Once a bank adopts FAS 91, recognizing a portion of loan fees as revenue to offset all or part of origination costs in the reporting period in which a loan is originated is no longer acceptable.
- Certain direct loan-origination costs specified in FAS 91 should be deferred and recognized over the life of the related loan as a reduction of the loan's yield. Loan-origination fees and related direct loan-origination costs for a given loan should be offset and only the net amount deferred and amortized.
- Direct loan-origination costs should be offset against related commitment fees and the net amounts should be deferred except for—
  - commitment fees (net of costs) when the likelihood that the commitment will be exercised is remote; in these cases, the fees should generally be recognized as service-fee income on a straight-line basis over the loan-commitment period, and
  - retrospectively determined fees, which are recognized as service-fee income when the amount of the fees are determined.

All other commitment fees (net of costs) are to be deferred over the entire commitment period and recognized as an adjustment of yield over the related loan's life or, if the commitment expires unexercised, recognized in income upon expiration of the commitment.

- Loan-syndication fees should be recognized by the bank managing a loan syndication (the syndicator) when the syndication is complete unless a portion of the syndication loan is

retained. If the yield on the portion of the loan retained by the syndicator is less than the average yield to the other syndication participants after considering the fees passed through by the syndicator, the syndicator should defer a portion of the syndication fee to produce a yield on the portion of the loan retained that is not less than the average yield on the loans held by the other syndication participants.

- Loan fees, certain direct loan-origination costs, and purchase premiums and discounts on loans are to be recognized as an adjustment of yield generally by the interest method based on the contractual term of the loan. However, if the bank holds a large number of similar loans for which prepayments are probable and if the timing and amount of prepayments can be reasonably estimated, the bank may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. Fees should not be recognized over the estimated average life of a group of loans.

Examiners should review the extent and nature of servicing activities to ensure that they are conducted in a safe and sound manner. Loan-origination fees and related direct loan-origination costs of loans held for sale should be accounted for in accordance with FAS 91, as discussed above. Improper practices should be criticized.

### Risk Management and the Valuation and Hedging of Mortgage-Servicing Assets Arising from Mortgage Banking Activities

A bank's board of directors and senior management are expected to take into account the potential exposure of both earnings and capital to changes in a bank's mortgage banking assets and operations under expected and stressed market conditions. Banks are expected to have comprehensive documentation that adequately substantiates and validates the carrying values of its mortgage-servicing assets (MSAs) and the underlying assumptions used to derive those values. The analyses and processes should be fully documented to support the amortization and timely recognition of impairment of the bank's MSAs. (See SR-03-4.)

The guidance that follows focuses on the risks associated with these aspects of mortgage banking: valuation and modeling processes, hedging activities, management information systems, and internal audit processes. When banks originate mortgage loans, they often sell the loans into the secondary market. Yet banks often retain and recognize the servicing of those MSAs, which are complex and volatile assets that are subject to interest-rate risk. MSAs can become impaired as interest rates fall and borrowers refinance or prepay their mortgage loans. This impairment can lead to earnings volatility and the erosion of capital, if the risks inherent in the MSAs are not properly hedged.

Banks are expected to follow Financial Accounting Standards Board Statement No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," when accounting for MSAs. In summary, FAS 140 requires the following accounting treatment for servicing assets (including MSAs):<sup>17</sup>

- initially record servicing assets at fair value, presumably the price paid if purchased, or at their allocated carrying amount based on relative fair values if retained in a sale or securitization;<sup>18</sup>
- amortize servicing assets in proportion to, and over the period of, estimated net servicing income; and
- stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets, assess the strata for impairment based on fair value, and report them on the balance sheet at the lower of unamortized cost or fair value through the use of valuation allowances.

Fair value is defined in FAS 140 as the amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

17. Further guidance on the accounting for servicing assets and liabilities can be found in the instructions for the Reports of Condition and Income (call report); FAS 140 FASB Staff Implementation Guide; and the AICPA Statement on Auditing Standards 101, "Auditing Fair Value Measurements and Disclosures."

18. FAS 140 indicates: "Typically, the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability."

Quoted market prices in active markets for similar assets provide the best evidence of fair value and must be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value must be based on the best information available. The estimate of fair value must consider prices for similar assets and the results of valuation techniques to the extent available.

### *Examination Concerns on the Valuation of Mortgage-Servicing Assets*

Banks involved in mortgage-servicing operations should use market-based assumptions that are reasonable and supportable in estimating the fair value of servicing assets. Specifically, bulk, flow, and daily MSA/loan pricing activities observed in the market should be evaluated to ensure that a bank's MSA valuation assumptions are reasonable and consistent with market activity for similar assets. Many banks also use models to estimate the fair value of their MSAs and substantiate their modeled estimate of MSA fair value by comparing the model output with general or high-level peer surveys. Such a comparison, however, is often performed without adequate consideration of the specific attributes of the bank's own MSAs.

Examiners should consider the following concerns as an indication that additional scrutiny is necessary:

- *The use of unsupported prepayment speeds, discount rates, and other assumptions in MSA valuation models.*  
(Assumptions are unsupported when they are not benchmarked to market participants' assumptions and the bank's actual portfolio performance across each product type.)
- *Questionable, inappropriate, or unsupported items in the valuation models (examples include retention benefits,<sup>19</sup> deferred tax benefits, captive reinsurance premiums, and income from cross-selling activities).*

(The inclusion of these items in the MSA valuation must be appropriate under generally accepted accounting principles (GAAP) and must also be consistent with what a willing

19. Retention benefits arise from the portion of the serviced portfolio that is expected to be refinanced with the bank in the future.

- buyer would pay for the mortgage-servicing contract. For example, when the inclusion of retention benefits as part of the MSA valuation is not adequately supported with market data, such inclusion will result in an overstatement of reported mortgage-servicing assets. Therefore, the inclusion will be deemed an unsafe and unsound practice.)
- *Disregard of comparable market data coupled with overreliance on peer-group surveys as a means of supporting assumptions and the fair value of MSAs.*  
(Management may use survey data for comparative purposes; however, such data are not a measure of or substitute for fair value.)
  - *Frequent changing of assumptions from period to period for no compelling reason, and undocumented policies and procedures relating to the MSA valuation process and oversight of that process.*
  - *Inconsistencies in the MSA valuation assumptions used in valuation, bidding, pricing, and hedging activities as well as, where relevant, in mortgage-related activities in other aspects of a bank's business.*
  - *Poor segregation of duties from an organizational perspective between the valuation, hedging, and accounting functions.*
  - *Failure to properly stratify MSAs for impairment-testing purposes.*  
(FAS 140 requires MSAs to be stratified based on one or more of the predominant risk characteristics of the underlying mortgage loans. Such characteristics may include financial asset type, size, interest rate, origination date, term, and geographic location. Banks are expected to identify a sufficient number of risk characteristics to adequately stratify each MSA and provide for a reasonable and valid impairment assessment. Stratification practices that ignore predominant risk characteristics are a supervisory concern.)
  - *Inadequate amortization of the remaining cost basis of MSAs, particularly during periods of high prepayments.*  
(Inadequate amortization often occurs because prepayment models are not adequately calibrated to periods of high prepayments. When these models underestimate runoff, the amount and period of estimated net servicing income are overstated.)
  - *Continued use of a valuation allowance for the impairment of a stratum of MSAs when repayment of the underlying loans at a rate faster than originally projected indicates the existence of an impairment for which a direct write-down should be recorded.*
  - *Failure to assess actual cash-flow performance.*  
(The actual cash flows received from the serviced portfolio must be established in order to determine the benefit of MSAs to the bank.)
  - *Failure to validate or update models for new information.*  
(Inaccuracies in valuation models can result in erroneous MSA values and affect future hedging performance. Models should be inventoried and periodically revalidated, including an independent assessment of all key assumptions.)

## Risk Management of Mortgage Banking Activities

The Federal Reserve expects state member banks to perform mortgage banking operations in a safe and sound manner. Management should ensure that detailed policies and procedures are in place to monitor and control mortgage banking activities, including loan production, pipeline (unclosed loans) and warehouse (closed loans) administration, secondary-market transactions, servicing operations, and management (including hedging) of mortgage-servicing assets. Reports and limits should focus on key risks, profitability, and proper accounting practices.

MSAs possess interest rate–related option characteristics that may weaken a bank's earnings and capital strength when interest rates change. Accordingly, banks engaged in mortgage banking activities should fully comply with all aspects of the federal banking agencies' policy on interest-rate risk.<sup>20</sup> In addition, banks with significant mortgage banking operations or mortgage-servicing assets should incorporate these activities into their critical planning processes and risk-management oversight. The planning process should include careful consideration of how the mortgage banking activities affect the bank's overall strategic, business, and asset-liability plans. Risk-management considerations include the potential exposure of both earnings and capital to changes in the value and performance of mortgage banking assets under expected and stressed market conditions. Furthermore, a bank's board of directors should

20. See SR-96-13, Joint Agency Policy Statement on Interest Rate Risk (June 26, 1996), and section 4090.1.



establish limits on investments in mortgage banking assets and evaluate and monitor such investment concentrations (on the basis of both asset and capital levels) on a regular basis.

During examinations of mortgage banking activities, examiners should review mortgage banking policies, procedures, and management information systems to ensure that the directors, managers, and auditors are adequately addressing the following matters.

### *Valuation and Modeling Processes*

- *Comprehensive documentation standards for all aspects of mortgage banking, including mortgage-servicing assets.*

(In particular, management should substantiate and validate the initial carrying amounts assigned to each pool of MSAs and the underlying assumptions, as well as the results of periodic reviews of each asset's subsequent carrying amount and fair value. The validation process should compare actual performance with predicted performance. Management should ensure proper accounting treatment for MSAs on a continuing basis.)

- *MSA impairment analyses that use reasonable and supportable assumptions.*

(Analyses should employ realistic estimates of adequate compensation,<sup>21</sup> future revenues, prepayment speeds, market-servicing costs, mortgage-default rates, and discount rates. Fair values should be based on market prices and underlying valuation assumptions for transactions in the marketplace involving similar MSAs. Management should avoid relying solely on peer-group surveys or the use of unsupported assumptions. The Federal Reserve encourages banks to obtain periodic third-party valuations by qualified market professionals to support the fair values of their MSAs and to update internal models.)

- *Comparison of assumptions used in valuation models to the bank's actual experience in order to substantiate the value of MSAs.*

(Management should measure the actual performance of MSAs by analyzing gross monthly cash flows of servicing assets relative to the

assumptions and projections used in each quarterly valuation. In addition, a comparison of the first month's actual cash received on new MSAs with the projected gross cash flows can help validate the reasonableness of initial MSA values prior to the impact of prepayments and discount rates. "Economic value" analysis is a critical tool in understanding the profitability of mortgage servicing to a bank; however, it is *not* a substitute for the estimation of the fair value of MSAs under GAAP.)

- *Review and approval of results and assumptions by management.*

(Given the sensitivity of the MSA valuation to changes in assumptions and valuation policy, any such changes should be reviewed and approved by management and, where appropriate, by the board of directors.)

- *Comparison of models used throughout the company including valuation, hedging, pricing, and bulk acquisition.*

(Companies often use multiple models and assumption sets in determining the values for MSAs depending on their purpose—pricing versus valuation. Any inconsistencies between these values should be identified, supported, and reconciled.)

- *Appropriate amortization practices.*

(Amortization of the remaining cost basis of MSAs should reflect actual prepayment experience. Amortization speeds should correspond to and be adjusted to reflect changes in the estimated remaining net servicing income period.)

- *Timely recognition of impairment.*

(Banks must evaluate MSAs for impairment at least quarterly to ensure amounts reported in the call report<sup>22</sup> are accurately stated. Banks will generally be expected to record a direct write-down of MSAs when, and for the amount by which, any portion of the unamortized cost of a mortgage-servicing asset is not likely to be recovered in the future.)

### *Mortgage Banking Hedging Activities*

- *Systems to measure and control interest-rate risk.*

(Hedging activities should be well developed and communicated to responsible personnel. Successful hedging systems will mitigate the

21. As defined in FAS 140, "adequate compensation" is "the amount of benefits of servicing [i.e., revenues from contractually specified servicing fees, late charges, and other ancillary sources] that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace."

22. Schedule RC-M, Memoranda, Item 2a.

impact of prepayments on MSA values and the effects of interest-rate risk in the mortgage pipeline and warehouse.)

- *Approved hedging products and strategies.* (Management should ensure appropriate systems and internal controls are in place to oversee hedging activities, including monitoring the effectiveness of hedging strategies and reviewing concentrations of hedge instruments and counterparties.)
- *Hedge accounting policies and procedures.* (Banks should ensure their hedge accounting methods are adequately documented and consistent with GAAP.)

### *Management Information Systems*

- *Accurate financial reporting systems, controls, and limits.* (At a minimum, the board should receive information on hedged and unhedged positions, mark-to-market analyses, warehouse aging, the valuation of MSAs, various rate shock-scenario and risk exposures, the creation of economic value, and policy exceptions whenever material exposure to MSAs exists.)
- *Systems that track quality-control exceptions.* (Quality-control reports should be analyzed to determine credit quality, loan characteristics and demographics, trends, and sources of problems. Sound quality-control programs are also beneficial in the early detection of deteriorating production quality and salability, as well as in the prevention and detection of fraudulent activities.)
- *Systems that track and collect required mortgage loan documents.* (Management should ensure adequate control processes are in place for both front-end-closing and post-closing loan documents. If mortgages are not properly documented, a bank may be forced to hold unsold mortgages for extended periods or repurchase mortgages that have been sold. Further, management should ensure that adequate analyses are performed and allowances are established for estimated probable losses arising from documentation deficiencies on closed loans.)
- *Systems that monitor and manage the risks associated with third-party originated loans.* (Banks often originate loans through broker and correspondent channels. Management should ensure that prudent risk-management

systems are in place for broker and correspondent approvals and ongoing monitoring, including controls on the appraisal and credit-underwriting process of third-party originated loans. Adequate due diligence of third-party relationships is necessary to help prevent the origination of loans that are of poor credit quality or are fraudulent. Delegated underwriting to brokers or correspondents warrants close supervision from senior management.)

### *Internal Audit*

- *Adequate internal audit coverage.* (Because of the variety of risks inherent in mortgage banking activities, internal auditors should evaluate the risks of and controls over their bank's mortgage banking operations. They should report audit findings, including identified control weaknesses, directly to the audit committee of the board or to the board itself. Board and management should ensure that internal audit staff possess the necessary qualifications and expertise to review mortgage banking activities or obtain assistance from qualified external sources.)

## INTERAGENCY ADVISORY ON ACCOUNTING AND REPORTING FOR COMMITMENTS TO ORIGINATE AND SELL MORTGAGE LOANS

On May 3, 2005, the Federal Reserve and the other federal financial institution regulatory agencies<sup>23</sup> (the agencies) issued an Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans. (See SR-05-10.)

The advisory provides guidance on the appropriate accounting and reporting for commitments to—

- originate mortgage loans that will be *held for resale*, and
- sell mortgage loans under mandatory-delivery and best-efforts contracts.

23. The agencies are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

Commitments to originate mortgage loans that will be held for resale are derivatives and must be accounted for at fair value on the balance sheet by the issuer. All loan-sales agreements, including both mandatory-delivery and best-efforts contracts, must be evaluated to determine whether the agreements meet the definition of a derivative under Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by Statement of Financial Accounting Standards No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" (collectively, FAS 133). A financial institution should also account for loan-sales agreements that meet the definition of a derivative at fair value on the balance sheet.

The advisory discusses the characteristics that should be considered in determining whether mandatory-delivery and best-efforts contracts are derivatives and the accounting and regulatory reporting treatment for both commitments to originate mortgage loans that will be held for resale and those loan-sales agreements that meet the definition of a derivative. The advisory also addresses the guidance that should be considered in determining the fair value of derivatives.

The advisory provides additional guidance on the application of FAS 133. Financial institutions are expected, including those that are *not* required to file reports with the Securities and Exchange Commission (SEC), to follow the guidance in SEC Staff Accounting Bulletin No. 105, "Application of Accounting Principles to Loan Commitments" (SAB 105).<sup>24</sup>

A financial institution is expected to account for and report derivative loan commitments and forward loan-sales commitments as derivatives in accordance with GAAP, which includes the use of valuation techniques that are reasonable and supportable in the determination of fair value. An institution's failure to account for and report derivative loan commitments and forward loan-sales commitments in regulatory reports in accordance with GAAP may be an unsafe and unsound practice.

24. Staff accounting bulletins (SAB) summarize the views of the SEC's staff regarding the application of generally accepted accounting principles.

## Accounting and Reporting

### *Accounting Policies*

Well-managed financial institutions have written and consistently applied accounting policies for commitments to originate mortgage loans that will be held for resale and to sell mortgage loans under mandatory-delivery and best-efforts contracts, including approved valuation methodologies and procedures to formally approve changes to those methodologies. The methodologies should be reasonable, objectively supported, and fully documented. Procedural discipline and consistency are key concepts in any valuation measurement technique. Institutions should ensure that internal controls, including effective independent review or audit, are in place to provide integrity to the valuation process. Institutions' practices should, therefore, reflect these concepts to ensure the reliability of their valuations of derivative loan commitments and forward loan-sales commitments.

### *Derivative Loan Commitments*

A financial institution should account for derivative loan commitments at fair value on the balance sheet, regardless of the manner in which the intended sale of the mortgage loans will be executed (e.g., under a best-efforts contract, a mandatory-delivery contract, or the institution's own securitization). An institution should report each fixed, adjustable, and floating derivative loan commitment as an "other asset" or an "other liability" in their regulatory reports based upon whether the individual commitment has a positive (asset) or negative (liability) fair value.<sup>25</sup>

With respect to floating derivative loan commitments, because the interest rate on such a commitment "floats" on a daily basis with market interest rates, the fair value of a floating derivative loan commitment approximates zero as long as the creditworthiness of the borrower has not changed. However, as with other derivative loan commitments, an institution must report the entire gross notional amount of floating

25. When preparing Reports of Condition and Income (Call Reports), fixed, adjustable, and floating derivative loan commitments should not be reported as unused commitments in Schedule RC-L, Derivatives and Off-Balance Sheet Items, because such commitments are to be reported as derivatives in this schedule.

derivative loan commitments in its regulatory reports.

Commitments to originate mortgage loans that will be held for investment purposes and commitments to originate other types of loans are not within the scope of FAS 133 and, therefore, are not accounted for as derivatives.<sup>26</sup> An institution should report the unused portion of these types of commitments, which are *not* considered derivatives, as “unused commitments” in its regulatory reports.

### *Forward Loan-Sales Commitments*

A financial institution should account for forward loan-sales commitments for mortgage loans as derivatives at fair value on the balance sheet. Each forward loan-sales commitment should be reported as an “other asset” or an “other liability” based upon whether the individual commitment has a positive (asset) or negative (liability) fair value.<sup>27</sup>

### *Netting of Contracts*

For balance-sheet-presentation purposes, FAS 133 does not provide specific guidance on financial-statement presentation.<sup>28</sup> A financial institution may not offset derivatives with negative fair values (liabilities) against those with positive fair values (assets), unless the criteria for “netting” under GAAP have been satisfied.<sup>29</sup> In addition, an institution may not offset

the fair value of forward loan-sales commitments against the fair value of derivative loan commitments (the pipeline) or mortgage loans held for sale (warehouse loans). Rather, forward loan-sales commitments must be accounted for separately at fair value, and warehouse loans must be accounted for at the lower of cost or market (commonly referred to as “LOCOM”)<sup>30</sup> (that is, “fair value”) with certain adjustments to the cost basis of the loans if hedge accounting is applied.

### *Hedge Accounting*

A financial institution should follow the guidance in FAS 133 when applying hedge accounting to its mortgage banking activities. If the FAS 133 qualifying criteria are met, an institution may apply—

- fair-value hedge accounting in a hedging relationship between forward loan-sales commitments (hedging instrument) and fixed-rate warehouse loans (hedged item), or
- cash-flow hedge accounting in a hedging relationship between forward loan-sales commitments (hedging instrument) and the forecasted sale of the warehouse loans and/or the loans to be originated under derivative loan commitments (forecasted transaction).<sup>31</sup>

If a financial institution does not apply hedge accounting, either because the FAS 133 hedge criteria are not met or the institution chooses not to apply hedge accounting, forward loan-sales commitments should be treated as nonhedging derivatives. If hedge accounting is not applied, an institution will account for its warehouse loans at the lower of cost or fair value. Because nonhedging forward loan-sales commitments are accounted for at fair value through earnings, such an approach causes volatility in reported earnings if the fair value of the warehouse loans increases above their cost basis. In this situation, the volatility is a result of recognizing the full

condition, fair-value amounts recognized for derivative contracts executed with the same counterparty under a master netting arrangement may be offset.

30. See Statement of Financial Accounting Standards No. 65, “Accounting for Certain Mortgage Banking Activities” (FAS 65), paragraph 4.

31. See FAS 133, paragraphs 20–21, and related FAS 133 guidance for hedging instruments, hedged items, and forecasted transactions that qualify for fair-value and cash-flow hedge accounting.

26. See FAS 133, paragraph 10(i).

27. Regardless of whether the underlying mortgage loans will be held for investment or for resale, commitments to purchase mortgage loans from third parties under either mandatory-delivery contracts or best-efforts contracts are derivatives if, upon evaluation, the contracts meet the definition of a derivative under FAS 133. An institution should report its loan-purchase commitments that meet the definition of a derivative at fair value on the balance sheet.

28. That is, FAS 133 does not provide specific guidance where, in the financial statements, the fair value of derivatives or the changes in the fair value of derivatives should be classified and presented on the financial statement.

29. When an institution has two (or more) derivatives with the same counterparty, contracts with positive fair values and negative fair values may be netted if the conditions set forth in FASB Interpretation No. 39, “Offsetting of Amounts Related to Certain Contracts” (FIN 39), are met. Those conditions are as follows: (1) each of the parties owes the other determinable amounts; (2) the reporting party has the right to set off the amount owed with the amount owed by the other party; (3) the reporting party intends to set off; and (4) the right of setoff is enforceable at law. In addition, without regard to the third

amount of any decline in the fair value of the forward loan-sales commitments in earnings while not adjusting the carrying amount of the warehouse loans above their cost basis.

### *Income-Statement Effect*

Unless cash-flow hedge accounting is applied, a financial institution should include the periodic changes in the fair value of derivative loan commitments and forward loan-sales commitments in current-period earnings. An institution should report these changes in fair value in either “other noninterest income” or “other noninterest expense,” but not as trading revenue, in their regulatory reports. However, an institution’s decision as to whether to report the changes in fair value in its regulatory reports in an income or expense line item should be consistent with its presentation of these changes in its general-purpose external financial statements (including audited financial statements)<sup>32</sup> and should be consistent from period to period.

## Valuation

### *Fair Value*

FAS 133 indicates that the guidance in Statement of Financial Accounting Standards No. 107, “Disclosures about Fair Value of Financial Instruments” (FAS 107), should be followed in determining the fair value of derivatives.<sup>33</sup> That guidance provides that quoted market prices are the best evidence of the fair value of financial instruments. However, when quoted market prices are not available, which is typically the case for derivative loan commitments and forward loan-sales commitments, estimates of fair value should be based on the best information available in the circumstances (e.g., valuation techniques based on estimated expected future cash flows). When expected future cash flows are used, they should be the institution’s best estimate based on reasonable and supportable assumptions and projections.

Estimates of fair value should consider prices for similar assets or similar liabilities and the results of valuation techniques to the extent available in the circumstances. In the absence of (1) quoted market prices in an active market,

(2) observable prices of other current market transactions, or (3) other observable data supporting a valuation technique, the transaction price represents the best information available with which to estimate fair value at the inception of an arrangement.

A financial institution should not recognize an unrealized gain or loss at inception of a derivative instrument unless the fair value of that instrument is obtained from a quoted market price in an active market or is otherwise evidenced by comparison to other observable current market transactions or based on a valuation technique incorporating observable market data.<sup>34</sup> Based on this guidance, derivative loan commitments generally would have a zero fair value at inception.<sup>35</sup> However, subsequent changes in the fair value of a derivative loan commitment must be recognized in financial statements and regulatory reports (e.g., changes in fair value attributable to changes in market interest rates).

When estimating the fair value of derivative loan commitments and those best-efforts contracts that meet the definition of a derivative, a financial institution should consider predicted “pull-through” (or, conversely, “fallout”) rates. A pull-through rate is the probability that a derivative loan commitment will ultimately result in an originated loan. Some factors that may be considered in arriving at appropriate pull-through rates include (but are not limited to) the origination channel [which may be either internal (retail) or external (wholesale or correspondent, to the extent the institution rather than the correspondent closes the loan<sup>36</sup>)], current mortgage interest rates in the market versus the interest rate incorporated in the derivative loan commitment, the purpose of the mortgage (purchase versus refinancing), the stage of completion of the underlying application and underwriting process, and the time remaining until the

34. See footnote 3 in Emerging Issues Task Force Issue No. 02-3 (EITF 02-3), “Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities.”

35. If a potential borrower pays the lender a fee upon entering into a derivative loan commitment (e.g., a rate-lock fee), there is a transaction price, and the lender should recognize the derivative loan commitment as a liability at inception using an amount equal to the fee charged to the potential borrower.

36. If an institution commits to purchase a loan that will be closed by a correspondent in the correspondent’s name, the institution would have a loan-purchase commitment rather than a derivative loan commitment. Refer to footnote 27.

32. See footnote 28 above.

33. See FAS 133, paragraph 17.

expiration of the derivative loan commitment. Estimates of pull-through rates should be based on historical information for each type of loan product adjusted for potential changes in market interest rates that may affect the percentage of loans that will close. An institution should not consider the pull-through rate when reporting the notional amount of derivative loan commitments in regulatory reports but, rather, must report the entire gross notional amount.

### SAB 105

In March 2004, the SEC issued SAB 105 to provide guidance on the proper accounting and disclosures for derivative loan commitments. SAB 105 is effective for derivative loan commitments entered into after March 31, 2004. SAB 105 indicates that the expected future cash flows related to the associated servicing of loans should not be considered in recognizing derivative loan commitments. Incorporating expected future cash flows related to the associated servicing of the loan essentially results in the immediate recognition of a servicing asset. Servicing assets should only be recognized when the servicing asset has been contractually separated from the underlying loan by sale or securitization of the loan with servicing retained.<sup>37</sup> Further, no other internally developed intangible assets (such as customer-relationship intangible assets) should be recognized as part of derivative loan commitments. Recognition of such assets would only be appropriate in a third-party transaction (for example, the purchase of a derivative loan commitment either individually, in a portfolio, or in a business combination).

## Standard-Setter Activities

Financial institutions should be aware that the SEC or the Financial Accounting Standards Board (FASB) may issue additional fair-value, measurement, or recognition guidance in the future (e.g., a fair-value measurement statement). To the extent that additional guidance is issued, institutions must also consider the guidance in developing fair-value-estimate method-

ologies for derivative loan commitments and forward loan-sales commitments as well as measuring and recognizing such derivatives.

## Changes in Accounting for Derivative Loan Commitments and Loan-Sales Agreements

Financial institutions should follow Accounting Principles Board Opinion No. 20 (APB 20), "Accounting Changes,"<sup>38</sup> if a change in their accounting for derivative loan commitments, best-efforts contracts, or mandatory-delivery contracts is necessary. APB 20 defines various types of accounting changes and addresses the reporting of corrections of errors in previously issued financial statements. APB 20 states, "[e]rrors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared."

For regulatory reporting purposes, a financial institution must determine whether the reason for a change in its accounting meets the APB 20 definition of an accounting error. If the reason for the change meets this definition, the error should be reported as a prior-period adjustment if the amount is material. Otherwise, the effect of the correction of the error should be reported in current earnings.

If the effect of the correction of the error is material, a financial institution should also consult with its primary federal regulatory agency to determine whether any of its prior regulatory reports should be amended. If amended regulatory reports are not required, the institution should report the effect of the correction of the error on prior years' earnings, net of applicable taxes, as an adjustment to the previously reported beginning balance of equity capital. For the Call Report, the institution should report the amount of the adjustment in Schedule RI-A, item 2, "Restatements due to corrections of material accounting errors and changes in accounting principles," with an explanation in Schedule RI-E, item 4.

The effect of the correction of the error on income and expenses since the beginning of the

37. See Statement of Financial Accounting Standards No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," paragraph 61.

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

year in which the error is corrected should be reflected in each affected income and expense account on a year-to-date basis beginning in the next quarterly income statement (Call Report) to be filed and not as a direct adjustment to retained earnings.

## Definitions of Terms Used in the Advisory

### *Derivative Loan Commitment*

The term *derivative loan commitment* refers to a lender's commitment to originate a mortgage loan that will be held for resale. Notwithstanding the characteristics of a derivative set forth in FAS 133, these commitments to originate mortgage loans *must* be accounted for as derivatives by the issuer under FAS 133 and include, but are not limited to, those commonly referred to as *interest-rate-lock commitments*.

In a derivative loan commitment, the lender agrees to extend credit to a borrower under certain specified terms and conditions in which the interest rate and the maximum amount of the loan<sup>39</sup> are set prior to or at funding. Under the agreement, the lender commits to lend funds to a potential borrower (subject to the lender's approval of the loan) on a fixed- or adjustable-rate basis, regardless of whether interest rates change in the market, or on a floating-rate basis. In a typical derivative loan commitment, the borrower can choose to—

- “lock in” the current market rate for a fixed-rate loan (i.e., a fixed derivative loan commitment);
- “lock in” the current market rate for an adjustable-rate loan that has a specified formula for determining when and how the interest rate will adjust (i.e., an adjustable derivative loan commitment); or
- wait until a future date to set the interest rate and allow the interest rate to “float” with market interest rates until the rate is set (i.e., a floating derivative loan commitment).

Derivative loan commitments vary in term and expire after a specified time period (e.g., 60 days

after the commitment date). Additionally, derivative loan commitments generally do not bind the potential borrower to obtain the loan, nor do they guarantee that the lender will approve the loan once the creditworthiness of the potential borrower has been determined.

### *Forward Loan-Sales Commitment*

The term *forward loan-sales commitment* refers to either (1) a mandatory-delivery contract or (2) a best-efforts contract that, upon evaluation under FAS 133, meets the definition of a derivative.

### *Mandatory-Delivery Contract*

A *mandatory-delivery contract* is a loan-sales agreement in which a financial institution commits to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. If the institution fails to deliver the amount of mortgages necessary to fulfill the commitment by the specified date, it is obligated to pay a “pair-off” fee, based on then-current market prices, to the investor to compensate the investor for the shortfall. Variance from the originally committed principal amount is usually permitted, but typically may not exceed 10 percent of the committed amount.

All loan-sales agreements must be evaluated to determine whether they meet the definition of a derivative under FAS 133.<sup>40</sup> A mandatory-delivery contract has a specified underlying (the contractually specified price for the loans) and notional amount (the committed loan-principal amount), and requires little or no initial net investment. Additionally, a mandatory-delivery contract requires or permits net settlement or the equivalent thereof as the institution is obligated under the contract to either deliver mortgage loans or pay a pair-off fee (based on the then-current market prices) on any shortfall on the delivery of the committed loan-principal amount. Since the option to pay a pair-off fee accomplishes net settlement, it is irrelevant as to whether the mortgage loans to be delivered are considered readily convertible to cash.<sup>41</sup> Based

39. In accordance with the “Background Information and Basis for Conclusions” in Statement of Financial Accounting Standards No. 149 (FAS 149), the notional amount of a derivative loan commitment is the maximum amount of the borrowing. See FAS 149, paragraph A27.

40. See FAS 133, paragraph 6, for the characteristics of a financial instrument or other contract that meets the definition of a derivative.

41. See FAS 133, paragraph 57(c)(1), for a description of

on these characteristics, a mandatory-delivery contract meets the definition of a derivative at the time an institution enters into the commitment.

### *Best-Efforts Contract*

The term *best-efforts contract* refers to a loan-sales agreement in which a financial institution commits to deliver an individual mortgage loan of a specified principal amount and quality to an investor if the loan to the underlying borrower closes. Generally, the price the investor will pay the seller for an individual loan is specified prior to the loan being funded (e.g., on the same day the lender commits to lend funds to a potential borrower). A best-efforts contract that has all of the following characteristics would meet the definition of a derivative:

- an underlying (e.g., the price the investor will pay the seller for an individual loan is specified in the contract)
- a notional amount (e.g., the contract specifies the principal amount of the loan as an exact dollar amount or as a principal range with a determinable maximum amount<sup>42</sup>)
- requires little or no initial net investment (e.g., no fees are exchanged between the seller and investor upon entering into the agreement, or a fee that is similar to a premium on other option-type contracts is exchanged)
- requires or permits net settlement or the equivalent thereof (for example, the seller is contractually obligated to either deliver the loan to the investor if the loan closes or pay a pair-off fee, based on then-current market prices, to the investor to compensate the investor if the loan closes and is not delivered. Since the option to pay a pair-off fee accomplishes net settlement, it is irrelevant as to whether the loan to be delivered is considered readily convertible to cash.).

### *Master Agreement*

A financial institution may enter into one of several types of arrangements with an investor

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contracts that have terms that implicitly or explicitly require or permit net settlement.

42. The use of a maximum amount as the notional amount of a best-efforts contract is consistent with the loan-commitment discussion in the “Background Information and Basis for Conclusions” in FAS 149. See FAS 149, paragraph A27.

to govern the relationship between the institution and the investor and set the parameters under which the institution will deliver individual mortgage loans through separate best-efforts contracts. Such an arrangement might include, for example, a *master agreement* or an *umbrella contract*. These arrangements may specify an overall maximum principal amount of mortgage loans that the institution may deliver to the investor during a specified time period, but generally they do not specify the price the investor will pay for individual loans. Further, while these arrangements may include pair-off-fee provisions for loans to be sold under individual best efforts contracts covered by the arrangements, the seller is neither contractually obligated to deliver the amount of mortgages necessary to fulfill the maximum principal amount specified in the arrangement nor required to pay a pair-off fee on any shortfall. Because these arrangements generally either do not have a specified underlying or determinable notional amount or do not require or permit net settlement or the equivalent thereof, the arrangements typically do not meet the definition of a derivative. As discussed above, an individual best-efforts contract governed by one of these arrangements may, however, meet the definition of a derivative.

As the terms of individual best-efforts contracts and master agreements or umbrella contracts vary, a financial institution must carefully evaluate such contracts to determine whether the contracts meet the definition of a derivative in FAS 133.

### Example of the Accounting for Commitments to Originate and Sell Mortgage Loans<sup>43</sup>

#### *ABC Mortgage Financial Institution (Best-Efforts Contracts and No Application of Fair-Value Hedge Accounting)*

The following simplified example was developed to provide a financial institution that has a limited number of derivative loan commitments

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43. This example uses the definitions and concepts presented in the body of the Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans (the interagency advisory). Reference should be made to the interagency advisory for clarification of the terms and concepts used in this example.



general guidance on one approach that may be used to value such commitments.<sup>44</sup> This example also illustrates the regulatory reporting requirements for derivative loan commitments and forward loan-sales commitments.

The guidance in this example is for illustrative purposes only as there are several ways that a financial institution might estimate the fair value of its derivative loan commitments. A second approach to valuing derivative loan commitments is described in *Derivative Loan Commitments Task Force Illustrative Disclosures on Derivative Loan Commitments*, a practice aid developed by staff of the American Institute of Certified Public Accountants (AICPA) and a task force comprising representatives from the financial services, mortgage banking, and public accounting communities.<sup>45</sup> As indicated in the body of the interagency advisory, a financial institution must consider the guidance in FAS 133, FAS 107, EITF 02-3, and SAB 105 in measuring and recognizing derivative loan commitments and forward loan-sales commitments. In addition, an institution should be aware that the SEC or the FASB may issue additional guidance in the future that may alter certain aspects of this example.

*Background.* ABC Mortgage Financial Institution (ABC) enters into fixed, adjustable, and floating derivative loan commitments to originate mortgage loans that it intends to sell. The institution accounts for the commitments as derivative financial instruments as required under FAS 133.

ABC enters into best-efforts contracts with a mortgage investor under which it commits to deliver certain loans that it expects to originate under derivative loan commitments (i.e., the pipeline) and loans that it has already originated and currently holds for sale (i.e., warehouse loans). ABC and the mortgage investor agree on the price that the investor will pay ABC for an individual loan with a specified principal amount prior to the loan being funded. Once the price that the mortgage investor will pay ABC for an individual loan and the notional amount of the loan are specified, and ABC is obligated to

deliver the loan to the investor if the loan closes, the contract represents a forward loan-sales commitment. Under FAS 133, ABC accounts for these forward loan-sales commitments as derivative financial instruments.

At December 31 of a given year, the notional amounts of ABC's mortgage banking derivative loan commitments and forward loan-sales commitments are as follows:

**Table 1—Notional Amounts of Derivative Loan Commitments and Forward Loan-Sales Commitments**

	<i>Notional amount</i>
<i>Derivative loan commitments</i>	
Fixed-rate commitments	\$ 8,500,000
Adjustable-rate commitments	1,500,000
Floating-rate commitments	2,000,000
Total derivative loan commitments	\$12,000,000 [A] <sup>46</sup>
<i>Forward loan-sales commitments</i>	
Pipeline loan commitments	\$12,000,000
Warehouse loan commitments	8,000,000
Total forward loan-sales commitments	\$20,000,000 [B]

Market interest rates have changed throughout the time period that ABC's derivative loan commitments and forward loan-sales commitments have been outstanding. Some of the fixed-rate commitments are at rates above current market rates while others are at rates at or below current market rates. All of ABC's adjustable-rate commitments are at rates below current market rates.

Based on its past experience, ABC estimates a pull-through rate of 70 percent on its fixed-rate commitments for which the locked-in rate is

44. Estimating fair values when quoted market prices are unavailable requires considerable judgment. Valuation techniques using simplified assumptions may sometimes be used (with appropriate disclosure in the financial statements) to provide a reliable estimate of fair value at a reasonable cost. See FAS 107, paragraphs 60–61.

45. The practice aid is available at [www.aicpa.org](http://www.aicpa.org).

46. Alpha references in table 1 and the text of this example refer to the "Reference" column in table 3.

above current market rates (i.e., 70 percent of the commitments will actually result in loan originations) and a pull-through rate of 85 percent for its fixed-rate commitments for which the locked-in rate is at or below current market rates. ABC also estimates a pull-through rate of 85 percent for all of its adjustable-rate commitments that are below market rates.

The pull-through-rate assumptions in this example have been simplified for illustrative purposes. In determining appropriate pull-through rates, a financial institution must consider all factors that affect the probability that derivative loan commitments will ultimately result in originated loans. Therefore, an institution is expected to have more granularity (i.e., stratification) in its application of pull-through-rate assumptions to its derivative loan commitments.

*Discussion of ABC’s approach to valuing derivative loan commitments and forward loan-sales commitments.* ABC estimates the fair value of its derivative loan commitments using the best information available in the circumstances because quoted market prices are not available. In this case, ABC uses valuation techniques that take into account current secondary-market loan-pricing information.<sup>47</sup> ABC had noted the

47. In general, source data for secondary-market loan-pricing information may include, for example, quotations from rate sheets; brokers; or electronic systems such as those provided by third-party vendors, market makers, or mortgage

appropriate reference price for the underlying loans on the day that each derivative loan commitment was given to a borrower and assigned an initial fair value of zero to each loan commitment consistent with the guidance in SAB 105 and EITF 02-3. At the end of the month, ABC compares the current reference price of each underlying loan with its initial reference price and calculates the price difference. ABC then calculates the fair value of these derivatives by multiplying the price difference by the estimated pull-through rate. This approach is illustrated in table 2 below.

As illustrated in table 2, ABC excludes time value from its fair-value-estimate methodology due to the short-term nature of the derivative loan commitments. As the exclusion of time value is not appropriate for all fair-value estimates, an institution must consider the terms of its specific agreements in determining an appropriate estimation methodology.

In the example in table 2, ABC estimated the initial reference price of the underlying loan to be originated under the commitment, excluding the value of the associated servicing rights, to be \$100,000. That is, at the date it entered into the fixed derivative loan commitment with the borrower, ABC estimated it would receive \$100,000, excluding the value of the associated servicing

loan investors. When secondary-market loan-pricing information that includes the value of servicing rights is used, the fair value of the derivative loan commitments ultimately must exclude any value attributable to servicing rights.

**Table 2—ABC’s Calculation of the Fair Value of Derivative Loan Commitments: An Example of a Fixed Derivative Loan Commitment for Which the Locked-In Rate Is Above the Current Market Rate\***

<i>Notional amount of loan</i>	<i>Initial reference price of loan to be originated under commitment—excluding servicing rights</i>	<i>Current reference price of loan to be originated under commitment—excluding servicing rights</i>	<i>Price difference</i>	<i>Pull-through rate</i>	<i>Fair value of derivative loan commitment</i>
(1)	(2)	(3)	[(3) - (2)]	(4)	[(3) - (2)] × (4)
\$100,000	\$100,000	\$100,500	\$500	70%	\$350

\* The example in this table presents the fair-value calculation for one derivative loan commitment. The fair value of this derivative, which is positive, would be added to all the other derivative loan commitments with positive fair values. Netting derivatives with positive fair values (assets) against derivatives with negative fair values (liabilities) is not permitted unless the conditions stipulated in FIN 39 are met. Refer to footnote 29 of the interagency advisory.

rights, if the underlying loan was funded and sold in the secondary market on that day. Because this amount is equal to the notional amount of the loan, ABC would not experience a gain or loss on the sale of the underlying loan (before considering the effect of the loan-origination fees and costs associated with the loan). As such, the fair value of this derivative loan commitment would be zero, and there would not be any unrealized gain or loss at the inception of the derivative loan commitment. This may not be true for all derivative loan commitments.

ABC defers all unrealized gains and losses at the inception of its derivative loan commitments until the underlying loans are sold. ABC's policy is based on the short-term nature of its derivative loan commitments and was adopted in order to not accelerate the timing of gain recognition. As this practice may not be appropriate for all derivative loan commitments or other derivatives initially accounted for under EITF 02-3, and due to the lack of authoritative guidance in this area, an institution should consult with its accounting advisers concerning the appropriate accounting for its specific agreements.

After applying the methodology described above to individual derivative loan commitments, ABC aggregates the fair values of the derivative loan commitments by type (i.e., fixed, adjustable, and floating) and by whether the commitments have above-, at-, or below-market rates. The fair values of the fixed derivative loan commitments with above-market rates, adjusted for the appropriate pull-through rate, total \$21,000 [C], which represents an asset. The aggregate fair value of the fixed derivative loan commitments that have at- or below-market rates, adjusted for the appropriate pull-through rate, sums to (\$31,000) [D], which represents a liability. For the adjustable derivative loan commitments, the aggregate fair value, adjusted for the pull-through rate, is approximately (\$2,000) [E], which is also a liability. The fair value of the floating derivative loan commitments approximates zero.

ABC also estimates the fair value of its forward loan-sales commitments outstanding at the end of the month using a similar methodology as that described above. Based upon this information, ABC determines that the estimated fair value of the forward loan-sales commitments related to its derivative loan commitments and warehouse loans with above-market rates is approximately (\$45,000) [F], which represents a

liability, because current market interest rates for comparable mortgage loans are lower than the rates in effect when the derivative loan commitments were initiated. (Consequently, current offered delivery prices for similar commitments are greater than the delivery prices of ABC's existing forward loan-sales commitments. Therefore, the change in the fair value of ABC's forward loan-sales commitments since they were entered into represents a loss.) The fair value of ABC's forward loan-sales commitments related to its derivative loan commitments and warehouse loans with at- or below-market rates is estimated to be \$50,000, which is an asset.<sup>48</sup>

*Regulatory reporting.* The following table illustrates the regulatory reporting requirements for the derivative-related dollar amounts cited in the example.

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48. The absolute value of the fair value of the forward loan-sales commitments is greater than the absolute value of the fair value of the related derivative loan commitments because the forward loan-sales commitments also apply to, and act as an economic hedge of, ABC's warehouse loans. ABC accounts for its warehouse loans at the lower of cost or fair value in accordance with FAS 65. In this example, ABC does not apply hedge accounting to its warehouse loans.

Table 3—Regulatory Reporting Implications for Derivative Loan Commitments and Forward Loan-Sales Commitments

	<i>Amount</i>	<i>Reference</i>
<i>Derivative loan commitments</i>		
Notional amount of “over-the-counter written options” <sup>49</sup>	\$12,000,000	[A]
Derivatives with a <i>positive</i> fair value held for purposes other than trading (asset)	\$21,000	[C]
Derivatives with a <i>negative</i> fair value held for purposes other than trading (liability)	\$33,000	[D + E]
<i>Forward loan-sales commitments</i>		
Notional amount of “forward contracts”	\$20,000,000	[B]
Derivatives with a <i>positive</i> fair value held for purposes other than trading (asset)	\$50,000	[G]
Derivatives with a <i>negative</i> fair value held for purposes other than trading (liability)	\$45,000	[F]
<i>Derivative loan commitments and forward loan-sales commitments</i>		
Total notional amount of derivative contracts held for purposes other than trading	\$32,000,000	[A + B]

As illustrated in table 3, depending upon particular market circumstances, individual derivative loan commitments and forward loan-sales commitments may have either positive or negative fair values, which ABC properly reports gross as assets or liabilities on its balance sheet.

49. Because derivative loan commitments are in certain respects similar to options, they are reported with “over-the-counter written options” for regulatory reporting purposes.

In addition, for regulatory reporting purposes, ABC consistently reports the periodic *changes* in the fair value of its derivative contracts in “other noninterest expense” in its income statement. Alternatively, ABC could have chosen to consistently report these fair-value changes in “other noninterest income” in its regulatory reports.

# Loan Portfolio Management

## Examination Objectives

Effective date November 2005

## Section 2040.2

1. To determine if policies, practices, procedures, and internal controls for loan portfolio management are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit and loan-review functions.
4. To determine the overall quality of the loan portfolio and how that quality relates to the soundness of the bank.
5. To be alert to indications of insufficiently rigorous risk assessment at banking institutions, particularly excessive reliance on strong economic conditions and robust financial markets to support the capacity of borrowers to service their debts, and inadequate stress testing.
6. To be attentive when reviewing an institution's lending policies and its assessment and monitoring of credit risk to ensure that undue reliance on favorable conditions does not lead to the delayed recognition of emerging weaknesses in some loans.
7. To ascertain whether there has been significant and undue reliance by the institution on favorable assumptions about borrowers or the economy and financial markets. If so, to carefully consider downgrading, under the applicable supervisory rating framework, an institution's risk-management, management, or asset-quality ratings (or all three). If the institution's assumptions are deemed sufficiently significant, to consider downgrading its capital adequacy rating.
8. To determine if the bank has adequate policies, procedures, internal controls, and internal or external audit reviews that ensure its compliance (and its subsidiaries' compliance) with section 106(b) of the Bank Holding Company Act Amendments, the Board's regulations and orders, and the Board's interpretations for tying arrangements.
9. To ascertain, to the extent possible, that the bank's credit extensions did not include impermissible tying arrangements.
10. To determine that management has implemented satisfactory policies, procedures, and controls to address the risks inherent in mortgage banking activities.
11. To find out if the bank accounted for and reported the following transactions at their fair value: (1) its commitments to originate mortgage loans that were held for resale (derivatives) and (2) its loan-sales agreements that are derivatives. If so, to ascertain if these transactions were accounted for and reported—
  - a. in accordance with the instructions for the bank Call Report; generally accepted accounting principles (GAAP); SR-05-10 and its attached May 3, 2005, Inter-agency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans; and
  - b. based on reasonable and supportable valuation techniques, as prescribed by the above-mentioned guidance.
12. To determine if the banking organization's loan-review activities or other internal control and risk-management processes have been weakened by staff turnover, failure to commit sufficient resources, inadequate training, and reduced-scope or less-thorough internal loan reviews. To incorporate such findings into the determination of supervisory ratings.
13. To prepare, in a concise, reportable format, information on the bank's lending function.
14. To determine compliance with laws and regulations, including sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.
15. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Loan Portfolio Management

## Examination Procedures

Effective date April 2011

## Section 2040.3

### FIRST-DAY LETTER, PRE-EXAMINATION ANALYSIS

1. If selected for implementation, complete or update the loan portfolio management section of the internal control questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining procedures.
3. Request reports on the following from the bank, by department, as of the examination date, unless otherwise specified:

- a. past-due loans covering—
  - single-payment notes 30 days or more past maturity;
  - single-payment notes with interest due at specified intervals and demand notes on which interest is due and unpaid for 30 days or more; and
  - consumer, mortgage, or term loans, payable in regular installments in which one installment is due and unpaid for 30 days or more.

The following information should be included:

- name of the obligor
- original amount of the loan
- outstanding amount of the loan
- date the loan was made
- due date
- terms of the loan
- number of payments the loan is delinquent
- date of the borrower's last payment
- interest billing cycle
- date up to which interest is paid

For larger loans, the report should also include the purpose of the loan and any action being taken.

- b. loans in a nonaccrual status
- c. loans on which interest is not being collected in accordance with the terms of the loan
- d. loans whose terms have been modified by a reduction of interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms
- e. since the previous examination, loans transferred, either in whole or in part, to

another lending institution as a result of a sale, participation, or asset swap

- f. since the previous examination, loans acquired from another lending institution as a result of a purchase, participation, or asset swap
  - g. loans considered “problem loans” by management (This report may be either as of the examination date or as submitted to the officer's loan-review committee, loan and discount committee, or board of directors.)
  - h. loan commitments and contingent liabilities
    - i. loans secured by stock of other banks and loans secured by rights, interests, or powers of a savings and loan association
    - j. extensions of credit (including outstanding balances and any bank or personal charges on bank-owned or bank-issued credit cards) that have been issued to employees, officers, directors, and principal shareholders and their interests, specifying which officers are considered executive officers
    - k. for correspondent banks, extensions of credit to executive officers, directors, and principal shareholders and their interests
    - l. a list of correspondent banks
    - m. miscellaneous loan debit-and-credit suspense accounts
    - n. current interest-rate structure
    - o. officers' current lending authority
    - p. the nature and extent of servicing activities, including—
      - the aggregate volume and types of serviced loans,
      - the dollar volume of loans originated from out of territory,
      - the number of originations and sales year-to-date compared with the same period in the previous year, and
      - fee income from sales and servicing year-to-date compared with the same period in the previous year.
    - q. extensions of credit in the form of overnight overdrafts resulting from bank funds transfer activities
4. Obtain the following information:
- a. a copy of written policies covering all lending functions

- b. a statement of whether a standing committee administers the lending function
  - c. copies of reports furnished to the board for meetings
  - d. lists of directors, executive officers, and principal shareholders and their interests
  - e. a summary of the officer's borrowing report (debts to own and other banks)
5. Obtain a copy of the latest reports furnished to the loan and discount committee.
  6. Review the lending policies and updates thereto and determine, as loans and other extensions of credit are being reviewed, whether the institution's lending practices adhere to the board of directors' lending policies and procedures and if they require continued compliance with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.
  7. Abstract appropriate excerpts of the lending policies and updates on the following:
    - a. distribution of loans by category
    - b. geographic limitations
    - c. industrial concentration limitations
    - d. allowable or desirable ratios of loans to other balance-sheet accounts
    - e. lending authorities of committees and officers
    - f. any prohibited types of loans
    - g. maximum maturities for various types of loans
    - h. interest-rate structure
    - i. minimum down payments for various types of loans
    - j. collateral-appraisal policies including—
      - persons authorized to perform appraisals and
      - lending values of various types of property
    - k. financial information requirements by types of loans
    - l. limitations and guidelines for purchasing and selling loans either directly or through participations or swaps
    - m. guidelines for supplying complete and regularly updated credit information to purchasers of loans that the bank originated
    - n. guidelines for obtaining complete and regularly updated credit information on loans purchased from others
    - o. guidelines for loans to major stockholders, directors, officers, or their interests
    - p. guidelines for determining the creditworthiness of any institution or customer on whose behalf the bank executes funds transfers
    - q. loan-pricing policies and practices indicating that the institution may be unduly weighting the short-term benefit of retaining or attracting new customers through price concessions, while not giving sufficient consideration to potential longer-term consequences
    - r. policies reflecting any indications of insufficiently rigorous risk assessments, and, in particular, an excessive reliance on strong economic conditions and robust financial markets to support the capacity of borrowers to service their debts, as well as inadequate stress testing of the assumptions underlying the risk assessment
    - s. policies involving the institution's assessments and monitoring of credit risk to ensure that an undue reliance on favorable conditions does not lead the institution to delay recognition of emerging weaknesses in some loans

## LENDING POLICIES AND PROCEDURES, ASSET-LIABILITY MANAGEMENT

1. When more than one lending policy exists, determine that policies are internally consistent by reviewing the guidelines previously obtained.
2. Review minutes of the bank's loan and discount committee meetings to obtain—
  - a. present members and their attendance record,
  - b. the scope of work performed, and
  - c. any information deemed useful in the examination of specific loan categories or other areas of the bank.
3. Compare reports furnished to the board and the loan and discount committee and those received from the bank in step 3 of the "First-Day Letter, Pre-examination Analysis" section to determine any material differences and that they are transmitted to the board in a timely manner.
4. Perform the following steps for past-due loans:
  - a. Compare the following to determine any material inconsistencies:
    - the past-due loan schedule received in

- step 3 of the “First-Day Letter, Pre-examination Analysis” section
- delinquency reports submitted to the board



- list of loans considered “problem” loans by management
  - delinquency lists submitted for regulatory purposes
- b. Scan the delinquency lists submitted to the board to determine that reports are sufficiently detailed to evaluate risk factors.
  - c. Compile current aggregate totals of past-due paper including unplanned overdrafts not paid in 30 days.
5. Perform the following using the loan commitments and contingent liabilities schedule obtained in step 3 of the “First-Day Letter, Pre-examination Analysis” section:
    - a. Reconcile appropriate contingencies totals to memorandum ledger controls.
    - b. Review reconciling items for reasonableness.
  6. Consult with the examiner responsible for the asset/liability management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, have the examiners assigned to the various loan areas compile the information using bank records or other appropriate sources. See “Instructions for the Report of Examination,” section 6000.1, for considerations to be taken into account when compiling maturity information for the gap analysis.

## LOAN PORTFOLIO REVIEW AND ANALYSIS

1. Review the information received and perform the following procedures.
    - a. *Loan participations, loan purchases or sales, loan swaps.* The procedures are designed to ensure that loan transfers involving state member banks, bank holding companies, and nonbank affiliates are carefully evaluated to determine if they were carried out to avoid classification and to determine the effect of the transfer on the condition of the institution. In addition, the procedures are designed to ensure that the primary regulator of the other financial institution involved in the transfer is notified.
      - Check participation certificates and records and determine that the parties share in the risks and contractual payments on a pro rata basis.
      - Ascertain whether loans are purchased on a recourse basis and that loans are sold on a nonrecourse basis.
- Determine that the bank does not buy back or pay interest on defaulted loans in contradiction of the underlying agreement.
  - Compare the volume of loans purchased and sold with the total portfolio.
  - Determine that the bank has sufficient expertise to properly evaluate the volume of loans purchased and sold.
  - Determine if loans are sold primarily to accommodate overline needs of customers or to generate fee income.
  - Determine if loans are purchased or sold to affiliates or other companies in a chain banking organization; if so, determine that the purchasing companies are given sufficient information to properly evaluate the credit. (Section 23A of the Federal Reserve Act prohibits transfers of low-quality assets between affiliates. See section 4050.1, “Bank-Related Organizations.”)
  - Investigate any situations in which assets were transferred before the date of examination to determine if any were transferred to avoid possible criticism during the examination.
  - Determine whether any of the loans transferred were nonperforming at the time of transfer, classified at the previous examination, or for any other reason considered to be of questionable quality.
  - Review the bank’s policies and procedures to determine whether assets or participations purchased by the bank are given an independent, complete, and adequate credit evaluation. If the bank is a holding company subsidiary or a member of a chain banking organization, review asset purchases or participations from affiliates or other known members of the chain to determine if the asset purchases are given an *arm’s-length* and *independent* credit evaluation by the purchasing bank.
  - Determine that any assets purchased by the bank are properly reflected on its books at fair market value (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such assets and an appropriate risk premium). Determine that appropriate write-

- offs are taken on any assets sold by the bank at less than book value.
- Determine that transactions involving transfers of low-quality assets to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and the holding company affiliate.
  - If poor-quality assets were transferred to or from another financial institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
    - name of originating and receiving institutions
    - type of assets involved and type of transfer (i.e., participation, purchase or sale, swap)
    - date (or dates) of transfer
    - total number and dollar amount of assets transferred
    - status of the assets when transferred (e.g., nonperforming, classified, etc.)
    - any other information that would be helpful to the other regulator
  - Review the sale and purchase of U.S. government-guaranteed loans and sale premiums.
    - Recommendations for originating and selling institutions:
      - (1) Examiners should review the extent and nature of activities in connection with the sale of government-guaranteed loans. Lax or improper management of the selling institution's servicing responsibilities should be criticized. Out-of-trade-area lending for the purpose of resale of any portion of U.S. government-guaranteed loans should be carefully reviewed to ensure that the practice is conducted in a safe and sound manner.
      - (2) All income, including servicing fees and premiums charged in lieu of servicing fees, asso-
    - Recommendations for purchasing institutions:
      - (1) Purchasers of U.S. government-guaranteed loans should be aware that the purchase premiums are not guaranteed and are not paid by the guaranteeing federal agency when the loans are prepaid. Because payment of premiums that do not reasonably relate to the yield on the loan can distort published financial reports by overstating the value of a financial institution's assets, it will generally be viewed as an unsafe and unsound banking practice for a financial institution to pay purchase premiums that result in a significant overstatement in the value of bank assets.
      - (2) Many government-guaranteed loans currently being originated and sold are variable rate. These variable-rate loans normally should not trade at anything more than a modest premium or discount from par. Examiners should carefully review any loans being sold or purchased at significant premiums and criticize any involvement with excessive premiums as an unsafe and unsound business practice. Excessive purchase premiums will be classified loss. The loans will be required to be revalued to the market value at the time of the acquisition and the excessive premiums will be charged against current earnings.
 

In addition, any unamortized loan premium on a government-guaranteed loan must be immediately charged against income if the loan is prepaid, regardless of whether payment is received from the borrower or the guaranteeing agency.

- b. *Loans serviced.*
- Determine that the bank exercises similar controls and procedures over loans serviced for others as it does for loans in its own portfolio.
  - Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as it does for loans in its own portfolio.
  - Ascertain whether the serviced loans are subject to a repurchase agreement or are backed by a standby letter of credit from the originating bank.
  - Compare the volume of serviced loans with the total portfolio.
  - Determine if out-of-territory originations are significant relative to loans serviced.
  - Determine if the volume of loans originated, sold, and serviced is consistent with the loan-servicing capabilities of management.
  - Ascertain that servicing fees and premiums charged in lieu of fees are amortized over the life of the loan.
2. Obtain the listing of Uniform Review of Shared National Credits, and update the listing based on information obtained in step 3 of the “First-Day Letter, Pre-examination Analysis” section.
  3. Distribute the applicable schedules and other information obtained in the preceding steps to the examiners performing the loan examination procedures. Request that the examiners test the accuracy of the information. Also, request that they perform the appropriate steps in section 2050.3, “Concentrations of Credit.”
  4. Determine the general distribution characteristics of the loan portfolio by—
    - a. determining the percentage of total loans in specific classes and
    - b. comparing loan-category distributions with policy guidelines.
  5. Obtain the results of the internal loan reviews of the loan department, and perform the following:
    - a. Determine any nonadherence to internally established policies, practices, procedures, and controls.
      - b. Compare the various department results to determine the extent of nonadherence and if it is systemwide.
    - c. Organize internal-guideline exceptions in order of their relative importance.
    - d. Organize and prepare a listing of violations of law and regulations.
    - e. Review loan classifications and assets listed for special mention to determine—
      - inclusion of all necessary information and
      - substantiation of classification.
    - f. Determine the aggregate amount of loans classified in each of the four levels of classification.
    - g. Compile a listing of all loans not supported by current and satisfactory credit information.
    - h. Compile a listing of all loans not supported by complete collateral documentation.
    - i. Determine the aggregate amount of out-of-area loans.
    - j. Compile a listing of low-quality loans transferred to or from another lending institution through purchases or sales or participations or swaps. Submit the listing to Reserve Bank supervisory personnel.
    - k. Review the separate procedures in section 2050.3 “Concentrations of Credit,” and determine—
      - if all necessary data are included,
      - if there is substantiation for including specific items in the report of examination as a concentration, and
      - if the concentration is undue or unwarranted.
    - l. Compute the following ratios, and compare them with computations from prior examinations:
      - total classified assets to tier 1 capital plus the allowance for loan and lease losses (ALLL)
      - weighted classified assets to tier 1 capital plus the ALLL
      - total classified assets to total assets
      - ALLL to total loans and leases
      - past-due and nonaccrual loans and leases to gross loans and leases

## TYING ARRANGEMENTS

1. Evaluate compliance with section 106(b) of the Bank Holding Company Act Amendments, the Board's regulations (section 225.7 of Regulation Y (12 CFR 225.7)), and the Board's interpretations of the prohibitions against tying arrangements. During the course of the bank's examination, examiners should focus on the bank's responsibility to oversee and safeguard against potentially illegal tying arrangements by the bank and its subsidiaries. Examiners are to thoroughly review and evaluate the following areas:
  - a. the bank's monitoring and oversight of compliance with section 106(b) and the Board's regulations
  - b. the bank's establishment and monitoring of internal controls and procedures that are intended to prevent illegal tie-ins by the bank and its subsidiaries (Determine if management and its internal auditors have periodically confirmed that there is full compliance with such an internal policy.)
  - c. the adequacy of the bank's written policies (including policy statements) and procedures pertaining to prohibited tying arrangements (Policies and procedures include statements that many tying arrangements are illegal, as well as specific examples of prohibited tie-in practices that are relevant to particular current product lines.)
  - d. documentation for the training of management and staff who are responsible for monitoring the bank and its subsidiaries for compliance with anti-tying provisions (Also review the adequacy of training on compliance with anti-tying requirements that is provided to the bank's other employees.)
  - e. the adequacy of the bank's internal loan reviews of pertinent bank extensions of credit to borrowers whose credit facilities or services may be susceptible to improperly imposed tying arrangements in violation of section 106(b) or the Board's regulations (See "Prohibitions Against Tying Arrangements" in section 2040.1 for the statutory and regulatory provisions and their exceptions.) The internal loan reviews should—
    - include reviews of insurance applications, particularly if the bank's insurance subsidiary maintains a consistently high penetration rate on credits granted by the bank or its bank subsidiaries, which could indicate the presence of voluntary or involuntary tying arrangements;
    - verify that the bank's internal loan-review policies require a periodic review of actual transactions that involve tying arrangements to ensure the permissibility of the tying arrangements under section 106(b), section 225.7 of the Board's Regulation Y, the Board's orders, and the Board's interpretations on tying arrangements;
    - evaluate the nature, terms, and conditions of all services provided to customers; and
    - review billing arrangements, the frequency of billing, the method of computation, and the basis for such fees.
2. During the examination review of borrowers' loans, review those extensions of credit whose credit facilities or services may result in tying arrangements imposed by the bank or its subsidiaries that are impermissible or in violation of section 106(b) or the Board's regulations. (See "Prohibitions Against Tying Arrangements" in section 2040.1.)
3. Review the adequacy of external and internal audits, including the audit's workpapers and procedures, to determine if the auditors adequately ensured compliance with the prohibitions on tying arrangements in section 106(b).
4. On the "Matters Requiring Board Attention," the "Comments and Conclusions," and the "Violations of Laws and Regulations" report pages (or their equivalent), report any significant comments on observed noncompliance with the prohibitions against tying arrangements. (Comments would also be appropriate if controls to prevent tie-ins had not been established.)

## MORTGAGE BANKING ACTIVITIES

1. Review the mortgage banking policies, procedures, and management information systems.

2. Determine whether the directors, managers, and auditors are adequately evaluating, monitoring, and maintaining internal controls over the valuation and modeling processes, hedging activities, management information systems, and the internal audit function.
  3. Review the bank's mortgage-servicing operations, and determine if market-based assumptions are used and if they are reasonable and supportable for estimating the fair value of servicing assets.
    - a. Ascertain whether management uses bulk, flow, and daily mortgage-servicing asset (MSA) or loan-pricing activities observed in the market to evaluate the bank's MSA valuation assumptions.
    - b. Determine if those assumptions are reasonable and consistent with the market activity for similar assets.
  4. With respect to management, determine—
    - a. if detailed policies and procedures are in place to monitor and control mortgage banking activities, including loan production, pipeline (unclosed loans) and warehouse (closed loans) administration, secondary-market transactions, servicing operations, and management (including hedging) of MSAs, and
    - b. if reports and limits focus on key risks, profitability, and proper accounting practices.
  5. Determine whether the bank has written and has consistently applied accounting policies to its commitments to originate mortgage loans that are held for resale and its commitments to sell mortgage loans under mandatory-delivery and best-efforts contracts.
  6. Find out if the bank has developed and uses approved valuation methodologies and procedures to obtain formal approval for changes to those methodologies.
    - a. Ascertain whether the valuation methodologies are reasonable, objectively supported, and fully documented.
    - b. Determine if the bank has internal controls, including an effective independent review or audit, in place that give integrity to the valuation process.
  7. If the bank issues fixed-, adjustable-, and floating-rate derivative loan commitments or forward loan-sales commitments, review an adequate sample that evidences the full coverage of these types of transactions.
    - a. Ascertain if these transactions were properly reported on the balance sheet as an “other asset” or an “other liability,” based on whether the individual commitment has a positive (asset) or negative (liability) fair value in accordance with the bank Call Report instructions.
  - b. Determine if the floating-rate derivative loan commitments and other derivative loan commitments were reported at their entire gross notional amount in the bank Call Report.
  - c. Find out if the balance sheet correctly presents (accounts for, discloses, and reports) all such transactions, including the netting of contracts, the application of hedge accounting to mortgage banking activities, the valuation of derivatives, and any material or other accounting changes for derivative loan commitments and loan-sales agreements. Also determine if there is compliance with the May 3, 2005, Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans and with generally accepted accounting principles (GAAP).
  - d. Ascertain if periodic changes in the fair value of derivative loan commitments and forward loan-sales commitments are reported in current-period earnings in either “other noninterest income” or “non-interest expense,” as appropriate.
8. Report to the central point of contact (CPC) or examiner-in-charge (EIC) any failure of bank management to follow (1) the bank's accounting and valuation policies for its commitments to originate mortgage loans that are held for resale and its commitments to sell mortgage loans, (2) the instructions for the bank Call Report, (3) the May 3, 2005, interagency advisory, or (4) GAAP.
  9. When additional examination scrutiny is needed, based on the examination findings, the supervisory concerns discussed in section 2040.1, the February 23, 2003, Interagency Advisory on Mortgage Banking (see SR-03-4 and its attachment), and the May 3, 2005, Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans (see SR-05-10 and its attachment), perform the comprehensive mortgage banking examination procedures found in the appendix section A.2040.3. (Section A.2040.3 is located in the “Appendix” section near the back of the manual.)

## PROBLEM LOANS AND CLASSIFICATION

1. Forward the total loss and doubtful classifications and their totals to the examiner assigned to analyze the adequacy of capital.
2. Compare management's list of "problem" loans from step 3 (under "First-Day Letter, Pre-examination Analysis") with the listing of classified loans to determine the extent of management's knowledge of its own loan problems.
3. Through information previously generated, determine the causes of existing problems or weaknesses within the system that have the potential to be future problems.

## ALLOWANCE FOR LOAN AND LEASE LOSSES (ALLL)

1. Forward the following information to the examiner assigned to review the ALLL:
  - a. a listing of loans considered "problem loans" by management
  - b. a listing of classified loans

## DISCUSSIONS WITH MANAGEMENT

1. Discuss results of the examination of the lending function with senior management of the bank.
2. During discussions with senior management, structure inquiries to—
  - a. gain insight into the general management lending philosophy, and
  - b. elicit management responses for correction of deficiencies.

## REGULATION O

1. During the course of all examinations of the lending activities of state member banks, determine whether the bank and its executive officers, directors, principal shareholders, and related interests of such persons have complied with the substantive restrictions as well as the reporting and disclosure requirements of Regulation O (12 CFR 215), the appropriate statutes (12 USC 375a and 375b, 12 USC

1972(2)), and the board of directors' lending and other policies. Civil money penalties may be assessed for noncompliance. Specific matters that should be addressed are as follows:

### a. *Reports of examination.*

- Each report of examination on the lending activities of state member banks should contain information as to the bank's compliance with the lending restrictions found at 12 USC 375a and 375b, 12 USC 1972(2), and Regulation O. Violations should be reported, as appropriate, in the following report pages of the Commercial Bank Report of Examination:

- Matters Requiring Board Attention
- Examination Conclusions and Comments
- Violations of Law and Regulations

### b. *Schedule RC-M.*

- The information from this schedule should be reviewed to verify the accuracy and completeness of the information reported in the Call Report. Complete and accurate preparation of this schedule is particularly important because Schedule RC-M provides important data on possible insider abuse. It also contains information that will be used to respond to public requests for information concerning loans to executive officers, directors, principal shareholders, and to related interests of such persons.
  - Examiners should verify that the bank has established procedures for compliance with the requirements of Regulation O for disclosing information on extensions of credit to its executive officers, directors, principal shareholders, and to related interests of such persons. The bank should maintain records of all public requests for information and the disposition of such requests.
  - Records of requests for information and the disposition of such requests may be disposed of by banks after two years from the date of request.
2. The examination procedures for checking compliance with the relevant law and regu-

lation covering bank insider lending activities and reporting requirements are as follows (the examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment):

When reviewing the bank's information on its loans to its insiders (that is, information on all types of loans including loan participations, loans purchased and sold, and loan swaps) perform the examination procedures listed below:

- Test the accuracy and completeness of the information on the bank's extended loans by comparing it with the trial balance or loans sampled.
- Review credit files on insider loans to determine that required information is available.
- Determine that loans to insiders do not contain terms that are more favorable than those afforded to other borrowers.
- Determine that loans to insiders do not involve more-than-normal risk of repayment or present other unfavorable features.
- Determine that loans to insiders, as defined by the various sections of Regulation O, do not exceed the imposed lending limits.
- If prior approval by the bank's board of directors was required for a loan to an insider, determine that such approval was obtained.
- Determine that there is compliance with the various reporting requirements for insider loans.
- Determine that the bank has made provisions to comply with the public disclosure requirements of Regulation O.
- Determine that the bank maintains records of such public requests and the disposition of the requests for a period of two years after the dates of the requests.
- Review the adequacy of the bank's policies and procedures that it uses to ensure that loans to insiders of the bank and its correspondent banks comply with 12 USC 1972(2), which prohibits extending loans with preferential terms.<sup>1</sup> Although the statutory and regulatory *reporting* require-

ments associated with 12 USC 1972(2) have been eliminated, the bank must still comply with the existing *substantive* restrictions in 12 USC 1972(2). In doing so, a bank may select any reasonably prudent method to ensure its compliance with the restrictions.

3. During the examinations of correspondent banks, loans to executive officers, directors, principal shareholders, and to related interests of such persons of respondent banks should be reviewed for any evidence of preferential lending. Such loans should be reviewed to—
  - determine whether they were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons;
  - involve more-than-normal risk of repayment; or
  - have other unfavorable features, such as not being supported by adequate credit information or being in violation of state lending limitations.

Although Regulation O no longer contains information related to the restrictions on lending to the insiders of correspondent banks, the statutory limitations still remain at 12 USC 1972(2).<sup>2</sup> Banks must still comply with these *substantive* restrictions. In doing so, a bank may select any reasonably prudent method to ensure compliance with the restrictions.

4. Determine if the bank provides employees or other insiders with bank-owned or bank-issued credit cards for use in conducting the bank's business.
  - a. Verify that the bank has a written policy that forbids or discourages an employee or other insider from using a bank-owned or bank-issued credit card for the insider's personal purposes and that the policy obligates the insider to promptly reimburse the bank.
  - b. To ascertain the bank's compliance with Regulation O, verify that the bank monitors the amount of personal charges outstanding on its bank-owned or bank-issued credit cards that are held by insiders

1. Based on an interim rule, effective December 11, 2006, Regulation O will no longer contain information related to restrictions on lending to the insiders of correspondent banks. (See 71 *Fed. Reg.* 71,472, December 11, 2006.)

2. The statutory and regulatory *reporting* requirements previously associated with 12 USC 1972 and Regulation O have been eliminated.

- so that the outstanding charges, when aggregated with all of an insider's other indebtedness owed to the bank, do not exceed \$15,000.
- c. To verify the bank's compliance with the market-terms requirement of Regulation O, determine if—
    - the bank requires employees and other insiders who use bank-owned or bank-issued credit cards for personal purposes to meet the bank's normal credit underwriting standards and
    - the bank has verified that its bank-owned or bank-issued credit cards do not have more preferential terms (for example, a lower interest rate or a longer repayment period) than the consumer credit cards offered by the bank.

### EXAMINATION REPORTING, RATINGS ASSIGNMENT, AND WORKPAPER RETENTION

1. In the appropriate report format, write general remarks, which may include—
  - a. the scope of the examination of the lending function;
  - b. the quality of internal policies, practices, procedures, and controls over the lending function;
2. If appropriate and after careful consideration, recommend downgrading, under the applicable supervisory rating framework, the institution's risk-management, management, or asset-quality ratings (or all three). Recommend downgrading its capital adequacy rating (if assumptions are sufficiently significant) when there is significant and undue reliance on favorable assumptions about borrowers, the economy, and financial markets, or when that reliance has slowed the recognition of loan problems.
3. Compile or prepare all information that provides substantiation for the general remarks.
4. Update the workpapers with any information that will facilitate future examinations.



# Loan Portfolio Management

## Internal Control Questionnaire

Effective date November 2005

## Section 2040.4

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

### LENDING POLICIES AND PROCEDURES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written loan portfolio management policies and objectives that—
  - a. establish suggested guidelines for the distribution of loans in the commercial, real estate, and installment categories?
  - b. establish geographic limits for loans?
  - c. establish suggested guidelines for aggregate outstanding loans in relation to other balance-sheet categories?
  - d. establish the loan authority of committees and individual lending officers?
  - e. define acceptable types of loans?
  - f. establish maximum maturities for various types of loans?
  - g. establish loan pricing?
  - h. establish an appraisal policy?
  - i. establish the minimum financial information required at the inception of credit?
  - j. establish limits and guidelines for purchasing paper?
  - k. establish guidelines for loans to bank directors, officers, principal shareholders, and their related interests?
  - l. establish collection procedures?
  - m. define the duties and responsibilities of loan officers and loan committees?
  - n. outline loan portfolio management objectives that acknowledge—
    - concentrations of credit within specific industries?
    - the need to employ personnel with specialized knowledge and experience?
    - community service obligations?
    - possible conflicts of interests?
  - o. ensure that all of the bank's loan portfolios are monitored and reviewed to ensure continued compliance with sections 23A and 23B of the Federal Reserve Act and Regulation W.
2. Are loan portfolio management policies and objectives reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are the following reported to the board of directors or its committees (indicate which) at their regular meetings (at least monthly):
  - a. past-due single-payment notes? (If so, indicate the minimum days past due for them to be included \_\_\_\_\_.)
  - b. notes on which interest only is past due? (If so, indicate the minimum days past due for them to be included \_\_\_\_\_.)
  - c. term loans on which one installment is past due? (If so, indicate the minimum days due for them to be included \_\_\_\_\_.)
  - d. total outstanding loan commitments?
  - e. loans requiring special attention?
  - f. new loans and loan renewals or restructured loans?
4. Are reports to be submitted to the board or its committees rechecked by a designated individual for possible omissions before the reports are submitted?
5. Are written applications required for all loans?
6. Does the bank maintain credit files for all borrowers?
7. Does the credit file contain information on—
  - a. the purpose of the loan?
  - b. the planned repayment schedule?
  - c. the disposition of loan proceeds?
8. Does the bank require periodic submission of financial statements by all borrowers whose loans are not fully secured by readily marketable collateral?
9. Is a tickler file maintained to ensure that current financial information is requested and received?
10. Does the bank require submission of audited financial statements based on the dollar amount of the commitment? (If so, state the dollar minimum for requiring \$\_\_\_\_\_.)
11. Does the bank perform a credit investigation on proposed and existing borrowers for new loan applications?

12. Is it required that all loan commitments be in writing?
13. Are lines of credit reviewed and updated at least annually?
14. Are borrowers' outstanding liabilities checked to appropriate lines of credit before granting the borrowers additional advances?
15. Does the bank employ a procedure for disclosure of a loan or combination of loans that are or will be secured by 25 percent of another insured financial institution's stock?
16. Does the bank employ procedures to ensure compliance with the requirements of the Lost and Stolen Securities Program (17 CFR 240.17f-1)? (See Internal Control Questionnaire questions 6–15 of section 4150.4 "Review of Regulatory Reports.")
17. Is there an internal review system (it may be a function of the internal audit department) that covers each department, and does it—
  - a. recheck interest, discount, and maturity-date computations?
  - b. reexamine notes for proper execution, receipt of all required supporting papers, and proper disclosure forms?
  - c. determine that loan approvals are within the limits of the bank's lending authorities?
  - d. determine that notes bear the initial of the loan officer?
  - e. ascertain that new loans are within the limitations set for the borrower by corporate resolution?
  - f. recheck the liability ledger to determine that new loans have been accurately posted?
18. Does the bank have a loan-review section or the equivalent?
19. Is the loan-review section independent of the lending function?
20. Are the initial results of the loan-review process submitted to a person or committee that is also independent of the lending function?
21. Are all loans exceeding a certain dollar amount selected for review?
22. Do lending officers recommend loans for review?
23. Is a method, other than those detailed in steps 21 or 22, used to select loans for review? (If so, provide details.)
24. Are internal reviews conducted at least annually for all lending areas?
25. In an officer-identification system, are guidelines in effect that define the consequences of an officer's withholding a loan from the review process?
26. Is the bank's problem-loan list periodically updated by the lending officers?
27. Does the bank maintain a list of loans reviewed, indicating the date of the review and the credit rating?
28. Does the loan-review section prepare summations to substantiate credit ratings, including pass loans?
29. Are loan-review summations maintained in a central location or in appropriate credit files?
30. Are follow-up procedures in effect for internally classified loans, including an update memorandum to the appropriate credit file?
31. Are officers and employees prohibited from holding blank signed notes in anticipation of future borrowings?
32. Are paid and renewed notes cancelled and promptly returned to customers?
33. Are loan records retained in accordance with the record-retention policy and legal requirements?
34. Are new notes microfilmed daily?
35. Is a systematic and progressively stronger follow-up-notice procedure used for delinquent loans?
36. Does the bank maintain loan interest-rate schedules for various types of loans?
37. Does the bank periodically update interest-rate schedules? If so, state the normal frequency of updates \_\_\_\_\_.
38. Does the bank maintain records in sufficient detail to generate the following information by type of advance:
  - a. the cost of funds loaned?
  - b. the cost of servicing loans, including overhead?
  - c. the cost factor of probable losses?
  - d. the programmed profit margin?
39. Has the bank conducted industry studies for those industries in which it is a substantial lender?
40. Are loan proceeds either credited to customers' accounts or released through issuance of official bank checks payable to the borrower?
41. Is a record of charged-off loans maintained by a person other than the one who has custody of the notes or receives payment? Is this record checked against the notes at least annually?

42. Are adequate procedures in effect with respect to recoveries?

## MORTGAGE BANKING ACTIVITIES

1. Are the assumptions used in the bank's valuation models supported when these assumptions are not benchmarked to market participants' assumptions and to the bank's actual portfolio performance across each product type?
2. Are there questionable, inappropriate, or unsupported items in the valuation models (for example, retention benefits, deferred tax benefits, captive reinsurance premiums, or income from cross-selling activities). The inclusion of such items in the bank's mortgage-servicing asset (MSA) valuation must be appropriate under generally accepted accounting principles (GAAP) and must also be consistent with what a willing buyer would pay for the mortgage-servicing contract.
3. Does bank management use comparable market data as a means of supporting model assumptions and the fair value of MSAs?
4. Does bank management frequently change the assumptions it uses in its MSA valuation models from period to period for no compelling reason?
5. Are there inconsistencies in the MSA valuation assumptions used in valuation, bidding, pricing, and hedging activities as well as, where relevant, in mortgage-related activities in other aspects of the bank's business?
6. Is there satisfactory segregation of duties from an organizational perspective between the valuation, hedging, and accounting functions for the bank's mortgage banking activities?
7. Does bank management use appropriate amortization practices for its MSAs?
8. Does the bank properly stratify MSAs for impairment-testing purposes?
9. Do the bank's MSA impairment analyses use reasonable and supportable assumptions?
10. Does bank management use a valuation allowance for the impairment of a stratum of MSAs when repayment of the underlying loans at a rate faster than originally projected indicates the existence of an impairment for which a direct write-down should be recorded?
11. Does bank management evaluate MSAs for impairment at least quarterly to ensure that amounts reported in the call report are accurately stated?
12. Does bank management measure the actual performance of MSAs by analyzing gross monthly cash flows of servicing assets relative to the assumptions and projections used in each quarterly valuation?
13. Does bank management validate or update models for new information?
14. Does bank management periodically inventory and revalidate its MSA valuation models, including an independent assessment of all key assumptions?
15. Does the bank obtain periodic third-party valuations by qualified market professionals to support the fair values of its MSAs and to update its internal models?
16. Does the bank have comprehensive documentation standards for all aspects of mortgage banking, including mortgage-servicing assets?
17. Does bank management and, where appropriate, the board of directors, review and approve results and assumptions of the bank's MSA valuation models?
18. Does bank management compare models used throughout the company, including valuation, hedging, pricing, and bulk acquisition, to identify inconsistencies? Are identified inconsistencies satisfactorily supported?
19. Does the bank have systems to measure and control interest-rate risk?
20. Does bank management ensure that appropriate systems and internal controls are in place to oversee hedging activities, including monitoring the effectiveness of hedging strategies and reviewing concentrations of hedge instruments and counterparties?
21. Does bank management ensure that the bank's hedge accounting methods are adequately documented and consistent with GAAP?
22. Does the bank's board receive information on hedged and unhedged positions, mark-to-market analyses, warehouse aging, the valuation of MSAs, various rate shock scenarios and risk exposures, the creation of economic value, and policy exceptions

- whenever material exposure to MSAs exists?
23. Does the bank have written and consistently applied accounting policies for its commitments to originate mortgage loans that are held for resale and its commitments to sell mortgage loans under mandatory-delivery and best-efforts contracts?
  24. Has the bank developed, and does it use, approved valuation methodologies and procedures to obtain formal approval for the changes to those methodologies?
    - a. Are the valuation methodologies reasonable, objectively supported, and fully documented?
    - b. Does the bank have internal controls, including an effective independent review or audit, in place that give integrity to the valuation process?
  25. If the bank issues fixed-, adjustable-, and floating-rate derivative loan commitments or forward loan-sales commitments, does it review an adequate sample that evidences the full coverage of these types of transactions?
    - a. Are these types of transactions properly reported on the balance sheet as an “other asset” or an “other liability” according to whether the individual commitment has a positive (asset) or negative (liability) fair value, in accordance with the bank Call Report instructions?
    - b. Are floating-rate derivative loan commitments and other derivative loan commitments reported at their entire gross notional amount in the bank Call Report?
    - c. Is the bank’s balance-sheet presentation of all such transactions (including the netting of contracts, the application of hedge accounting to mortgage banking activities, the valuation of derivatives, and any material or other accounting changes for derivative loan commitments and loan-sales agreements) accounted for and reported in accordance with the May 3, 2005, Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans and in accordance with generally accepted accounting principles (GAAP)?
    - d. Are periodic changes in the fair value of derivative loan commitments and forward loan-sales commitments reported in current-period earnings in either “other noninterest income” or “noninterest expense,” as appropriate?
  26. Has the bank’s management failed to follow the bank’s accounting and valuation policies for its commitments to originate mortgage loans that are held for sale and its commitments to sell mortgage loans, according to the instructions in the bank Call Report, the May 3, 2005, interagency advisory, or GAAP?
  27. Does the bank have satisfactory systems that track quality-control exceptions?
  28. Does bank management analyze the bank’s quality-control reports to determine credit quality, loan characteristics and demographics, trends, and sources of problems?
  29. Does the bank have satisfactory systems that track and collect required mortgage loan documents?
  30. Does bank management ensure that adequate control processes are in place for both front-end-closing and post-closing loan documents?
  31. Does the bank have satisfactory systems that monitor and manage the risks associated with third-party-originated loans?
  32. Does bank management ensure prudent risk-management systems are in place for broker and correspondent approvals and for ongoing monitoring, including controls on the appraisal and credit-underwriting process of third-party-originated loans?
  33. Is the bank’s internal audit coverage of its mortgage banking activities adequate?

## CONCLUSION

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

The Federal Reserve and the other federal banking and thrift regulatory agencies (the agencies)<sup>1</sup> issued the Interagency Guidance on Nontraditional Mortgage Product Risks on September 29, 2006. The guidance addresses both risk-management and consumer disclosure practices that institutions<sup>2</sup> should employ to effectively manage the risks associated with closed-end residential mortgage products that allow borrowers to defer repayment of principal and, sometimes, interest (referred to as nontraditional mortgage loans). (See SR-06-15.)

Residential mortgage lending has traditionally been a conservatively managed business with low delinquencies and losses and reasonably stable underwriting standards. However, during the past few years consumer demand has been growing, particularly in high-priced real estate markets, for nontraditional mortgage loans. These mortgage products include such products as “interest-only” mortgages, where a borrower pays no loan principal for the first few years of the loan, and “payment-option” adjustable-rate mortgages (ARMs), where a borrower has flexible payment options with the potential for negative amortization.<sup>3</sup>

While some institutions have offered nontraditional mortgages for many years with appropriate risk management and sound portfolio performance, the market for these products and the number of institutions offering them has expanded rapidly. Nontraditional mortgage loan products are now offered by more lenders to a wider spectrum of borrowers; these borrowers may not otherwise qualify for more traditional mortgage loans and may not fully understand the risks associated with nontraditional mortgage loans.

Many of these nontraditional mortgage loans are underwritten with less stringent income and asset verification requirements (reduced documentation) and are increasingly combined with simultaneous second-lien loans.<sup>4</sup> Such risk layering, combined with the broader marketing of nontraditional mortgage loans, exposes financial institutions to increased risk relative to traditional mortgage loans.

Given the potential for heightened risk levels, management should carefully consider and appropriately mitigate exposures created by these loans. To manage the risks associated with nontraditional mortgage loans, management should—

- ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower’s repayment capacity;
- ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice; and
- recognize that many nontraditional mortgage loans, particularly when they have risk-layering features, are untested in a stressed environment. As evidenced by experienced institutions, these products warrant strong risk-management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses (ALLL) that reflects the collectibility of the portfolio. The Federal Reserve expects institutions to effectively assess and manage the risks associated with nontraditional mortgage loan products.<sup>5</sup>

Institutions should use the guidance to ensure that risk-management practices adequately address these risks. Risk-management processes, policies, and procedures in this area will be carefully scrutinized. Institutions that do not adequately manage these risks will be asked to take remedial action.

This guidance focuses on the higher risk elements of certain nontraditional mortgage products, not the product type itself. Institutions with sound underwriting, adequate risk management,

1. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

2. The term *institution(s)* is used in the interagency guidance. As used in this section, *institutions* applies to Federal Reserve-supervised state member banks and their subsidiaries, and bank holding companies and their nonbank subsidiaries.

3. Interest-only and payment-option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed-rate products. Refer to the appendix for additional information on interest-only and payment-option ARM loans. This guidance does not apply to reverse mortgages; home equity lines of credit (HELOCs), other than as discussed in the Simultaneous Second-Lien Loans section; or fully amortizing residential mortgage loan products.

4. Refer to the appendix for additional information on reduced documentation and simultaneous second-lien loans.

5. Refer to the Interagency Guidelines Establishing Standards for Safety and Soundness in 12 CFR 208, appendix D-1.

and acceptable portfolio performance will not be subject to criticism merely for offering such products.

## NONTRADITIONAL MORTGAGE LOAN TERMS AND UNDERWRITING STANDARDS

When an institution offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins. Underwriting standards should also comply with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines.<sup>6</sup>

Central to prudent lending is the internal discipline to maintain sound loan terms and underwriting standards despite competitive pressures. Institutions are strongly cautioned against ceding underwriting standards to third parties that have different business objectives, risk tolerances, and core competencies. Loan terms should be based on a disciplined analysis of potential exposures and compensating factors to ensure that risk levels remain manageable.

### Qualifying Borrowers for Nontraditional Loans

Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as *payment shock*, this increase is of particular concern for payment-option ARMs where the borrower makes minimum payments that may result in negative amortization. Some institutions manage the potential for excessive negative amortization and payment shock by structuring the initial terms to limit the spread between the introductory interest rate and the fully indexed rate. Nevertheless, an institution's qualifying standards should recognize the potential impact of payment shock, especially for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores. Recognizing that an institution's underwriting criteria are based on multiple factors, an institution should consider these factors jointly in the qualification process and potentially it may de-

velop a range of reasonable tolerances for each factor. However, the criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower's characteristics and the product's attributes.

For all nontraditional mortgage loan products, an institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by final maturity at the fully indexed rate,<sup>7</sup> assuming a fully amortizing repayment schedule.<sup>8</sup> In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.<sup>9</sup>

Furthermore, the analysis of repayment capacity should avoid overreliance on credit scores as a substitute for income verification in the underwriting process. The higher a loan's credit risk, either from loan features or borrower characteristics, the more important it is to verify

7. The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11<sup>th</sup> District Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. In different interest-rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (for example, the MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.

8. The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a loan with a 5-year interest-only period and a 30-year term would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

9. The balance that may accrue from the negative amortization provision does not necessarily equate to the full negative amortization cap for a particular loan. The spread between the introductory or "teaser" rate and the accrual rate will determine whether a loan balance has the potential to reach the negative amortization cap before the end of the initial payment-option period (usually five years). For example, a loan with a 115 percent negative amortization cap but only a small spread between the introductory rate and the accrual rate may reach a 109 percent maximum loan balance before the end of the initial payment-option period, even if only minimum payments are made. The borrower could be qualified based on this lower maximum loan balance.

6. Refer to 12 CFR 208.51 subpart E and appendix C and 12 CFR 225 subpart G.

the borrower's income, assets, and outstanding liabilities.

## Collateral-Dependent Loans

Institutions should avoid the use of loan terms and underwriting practices that may heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins. Loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.<sup>10</sup> Institutions that originate collateral-dependent mortgage loans may be subject to criticism, corrective action, and higher capital requirements.

## Risk Layering

Institutions that originate or purchase mortgage loans that combine nontraditional features, such as interest-only loans with reduced documentation or a simultaneous second-lien loan, face increased risk. When features are layered, an institution should demonstrate that mitigating factors support the underwriting decision and the borrower's repayment capacity. Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance, and other credit enhancements. While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.

## Reduced Documentation

Institutions increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and unverified information for analysis of a borrower's repayment capacity and general creditworthiness, they should be used with caution. As the level of credit risk increases, the Federal Reserve expects an institution to more diligently verify and document a borrower's income and debt-reduction capacity.

<sup>10</sup> A loan will not be determined to be "collateral-dependent" solely through the use of reduced documentation.

Clear policies should govern the use of reduced documentation. For example, stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, institutions generally should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

## Simultaneous Second-Lien Loans

Simultaneous second-lien loans reduce owner equity and increase credit risk. Historically, as combined loan-to-value ratios rise, so do defaults. A delinquent borrower with minimal or no equity in a property may have little incentive to work with a lender to bring the loan current and avoid foreclosure. In addition, second-lien HELOCs typically increase borrower exposure to increasing interest rates and monthly payment burdens. Loans with minimal or no owner equity generally should not have a payment structure that allows for delayed or negative amortization without other significant risk-mitigating factors.

## Introductory Interest Rates

As a marketing tool for payment-option ARM products, many institutions offer introductory interest rates set well below the fully indexed rate. When developing nontraditional mortgage product terms, an institution should consider the spread between the introductory rate and the fully indexed rate. Since initial and subsequent monthly payments are based on these low introductory rates, a wide initial spread means that borrowers are more likely to experience negative amortization, severe payment shock, and an earlier-than-scheduled recasting of monthly payments. Institutions should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates.

## Lending to Subprime Borrowers

Mortgage programs that target subprime borrowers through tailored marketing, underwriting standards, and risk selection should follow the applicable interagency guidance on subprime

lending.<sup>11</sup> Among other things, the subprime guidance discusses circumstances under which subprime lending can become predatory or abusive. Institutions designing nontraditional mortgage loans for subprime borrowers should pay particular attention to this guidance. They should also recognize that risk-layering features in loans to subprime borrowers may significantly increase risks for the institution and the borrower.

### Non-Owner-Occupied Investor Loans

Borrowers financing non-owner-occupied investment properties should qualify for loans based on their ability to service the debt over the life of the loan. Loan terms should reflect an appropriate combined LTV ratio that considers the potential for negative amortization and maintains sufficient borrower equity over the life of the loan. Further, underwriting standards should require evidence that the borrower has sufficient cash reserves to service the loan, considering the possibility of extended periods of property vacancy and the variability of debt service requirements associated with nontraditional mortgage loan products.

## PORTFOLIO AND RISK-MANAGEMENT PRACTICES

Institutions should ensure that risk-management practices keep pace with the growth and changing risk profile of their nontraditional mortgage loan portfolios and changes in the market. Active portfolio management is especially important for institutions that project or have already experienced significant growth or concentration levels. Institutions that originate or invest in nontraditional mortgage loans should adopt more robust risk-management practices and manage these exposures in a thoughtful, systematic manner. To meet these expectations, institutions should—

- develop written policies that specify acceptable product attributes, production and portfolio limits, sales and securitization practices,

11. See SR-99-6, Subprime Lending and its attachment, Interagency Guidance on Subprime Lending, March 1, 1999, and SR-01-4, Subprime Lending and its attachment, interagency Expanded Guidance for Subprime Lending Programs, January 31, 2001.

and risk-management expectations;

- design enhanced performance measures and management reporting that provide early warning for increasing risk;
- establish appropriate ALLL levels that consider the credit quality of the portfolio and conditions that affect collectibility; and
- maintain capital at levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility. Institutions should hold capital commensurate with the risk characteristics of their nontraditional mortgage loan portfolios.

### Nontraditional Mortgage Loan Policies

An institution's policies for nontraditional mortgage lending activity should set acceptable levels of risk through its operating practices, accounting procedures, and policy exception tolerances. Policies should reflect appropriate limits on risk layering and should include risk-management tools for risk-mitigation purposes. Further, an institution should set growth and volume limits by loan type, with special attention for products and product combinations in need of heightened attention due to easing terms or rapid growth.

### Concentrations in Nontraditional Mortgage Products

Institutions with concentrations in nontraditional mortgage products should have well-developed monitoring systems and risk-management practices. Monitoring systems should keep track of concentrations in key portfolio segments such as loan types, third-party originations, geographic area, and property occupancy status. Concentrations also should be monitored by key portfolio characteristics such as non-owner-occupied investor loans and loans with (1) high combined LTV ratios, (2) high DTI ratios, (3) the potential for negative amortization, (4) credit scores of borrowers below established thresholds, and (5) risk-layered features. Further, institutions should consider the effect of employee incentive programs that could produce higher concentrations of nontraditional mortgage loans. Concentrations that are not effectively managed will be subject



to elevated supervisory attention and potential examiner criticism to ensure timely remedial action.

## Controls

An institution's quality control, compliance, and audit procedures should focus on mortgage lending activities posing high risk. Controls to monitor compliance with underwriting standards and exceptions to those standards are especially important for nontraditional loan products. The quality control function should regularly review a sample of nontraditional mortgage loans from all origination channels and a representative sample of underwriters to confirm that policies are being followed. When control systems or operating practices are found deficient, business-line managers should be held accountable for correcting deficiencies in a timely manner.

Since many nontraditional mortgage loans permit a borrower to defer principal and, in some cases, interest payments for extended periods, institutions should have strong controls over accruals, customer service, and collections. Policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk. Customer service and collections personnel should receive product-specific training on the features and potential customer issues with these products.

## Third-Party Originations

Institutions often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans. Institutions should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the quality of originations so that they reflect the institution's lending standards and compliance with applicable laws and regulations.

Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics. This will help institutions identify problems such as early payment

defaults, incomplete documentation, and fraud. If problems involving appraisals, loan documentation, credit, or consumer complaints are discovered, the institution should take immediate action. Remedial action could include more thorough application reviews, more frequent re-underwriting, and even termination of the third-party relationship.

## Risk Management of Secondary-Market Activity

The sophistication of an institution's secondary-market risk-management practices should be commensurate with the nature and volume of activity. Institutions with significant secondary-market activities should have comprehensive, formal strategies for managing risks.<sup>12</sup> Contingency planning should include how the institution will respond to reduced demand in the secondary market.

While third-party loan sales can transfer a portion of the credit risk, an institution remains exposed to reputation risk when credit losses on sold mortgage loans or securitization transactions exceed expectations. As a result, an institution may determine that it is necessary to repurchase defaulted mortgages to protect its reputation and maintain access to the markets. In the Federal Reserve's view, the repurchase of mortgage loans beyond the selling institution's contractual obligation is implicit recourse. Under the risk-based capital rules, a repurchasing institution would be required to maintain risk-based capital against the entire pool or securitization.<sup>13</sup> Institutions should familiarize themselves with these guidelines before deciding to support mortgage loan pools or buying back loans in default.

## Management Information and Reporting

Reporting systems should allow management to detect changes in the risk profile of its nontraditional mortgage loan portfolio. The structure and content should allow the isolation of key

12. Refer to SR-02-16, dated May 23, 2002, Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations and its attachment.

13. Refer to 12 CFR 208 and 225, appendix A, III.B.3.

loan products, risk-layering loan features, and borrower characteristics. Reporting should also allow management to recognize deteriorating performance in any of these areas before it has progressed too far. At a minimum, information should be available by (1) loan type (for example, interest-only mortgage loans and payment-option ARMs); (2) risk-layering features (for example, payment-option ARMs with stated income and interest-only mortgage loans with simultaneous second-lien mortgages); (3) underwriting characteristics (for example, LTV, DTI, and credit score); and (4) borrower performance (for example, payment patterns, delinquencies, interest accruals, and negative amortization).

Portfolio volume and performance should be tracked against expectations, internal lending standards, and policy limits. Volume and performance expectations should be established at the subportfolio and aggregate portfolio levels. Variance analyses should be performed regularly to identify exceptions to policies and prescribed thresholds. Qualitative analysis should occur when actual performance deviates from established policies and thresholds. Variance analysis is critical to the monitoring of a portfolio's risk characteristics and should be an integral part of establishing and adjusting risk-tolerance levels.

## Stress Testing

Based on the size and complexity of their lending operations, institutions should perform sensitivity analysis on key portfolio segments to identify and quantify events that may increase risks in a segment or the entire portfolio. The scope of the analysis should generally include stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the institution's immediate control. Stress tests typically assume rapid deterioration in one or more factors and attempt to estimate the potential influence on default rates and loss severity. Stress testing should aid an institution in identifying, monitoring, and managing risk, as well as developing appropriate and cost-effective loss-mitigation strategies. The stress testing results should provide direct feedback in determining underwriting standards, product terms, portfolio concentration limits, and capital levels.

## Capital and the Allowance for Loan and Lease Losses

Institutions should establish an appropriate ALLL for the estimated credit losses inherent in their nontraditional mortgage loan portfolios. They should also consider the higher risk of loss posed by layered risks when establishing their ALLL.

Moreover, institutions should recognize that their limited performance history with these products, particularly in a stressed environment, increases performance uncertainty. Capital levels should be commensurate with the risk characteristics of the nontraditional mortgage loan portfolios. Lax underwriting standards or poor portfolio performance may warrant higher capital levels.

When establishing an appropriate ALLL and considering the adequacy of capital, institutions should segment their nontraditional mortgage loan portfolios into pools with similar credit-risk characteristics. The basic segments typically include collateral and loan characteristics, geographic concentrations, and borrower qualifying attributes. Segments could also differentiate loans by payment and portfolio characteristics, such as loans on which borrowers usually make only minimum payments, mortgages with existing balances above original balances, and mortgages subject to sizable payment shock. The objective is to identify credit quality indicators that affect collectibility for ALLL measurement purposes. In addition, understanding characteristics that influence expected performance also provides meaningful information about future loss exposure that would aid in determining adequate capital levels.

Institutions with material mortgage banking activities and mortgage servicing assets should apply sound practices in valuing the mortgage servicing rights for nontraditional mortgages. The valuation process should follow generally accepted accounting principles and use reasonable and supportable assumptions.<sup>14</sup>

## CONSUMER PROTECTION ISSUES

While nontraditional mortgage loans provide flexibility for consumers, the Federal Reserve is

14. See SR-03-4, dated February 25, 2003, Interagency Advisory on Mortgage Banking and its attachment, which has the same title.

concerned that consumers may enter into these transactions without fully understanding the product terms. Nontraditional mortgage products have been advertised and promoted based on their affordability in the near term; that is, their lower initial monthly payments compared with traditional types of mortgages. In addition to apprising consumers of the benefits of nontraditional mortgage products, institutions should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. This information should be provided in a timely manner—before disclosures may be required under the Truth in Lending Act or other laws—to assist the consumer in the product selection process.

## Concerns and Objectives

More than traditional ARMs, mortgage products such as payment-option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization, neither of which may be fully understood by consumers. For example, consumer payment obligations may increase substantially at the end of an interest-only period or upon the “recast” of a payment-option ARM. The magnitude of these payment increases may be affected by factors such as the expiration of promotional interest rates, increases in the interest-rate index, and negative amortization. Negative amortization also results in lower levels of home equity as compared with a traditional amortizing mortgage product. When borrowers go to sell or refinance the property, they may find that negative amortization has substantially reduced or eliminated their equity in the property—even when the property has appreciated. The concern that consumers may not fully understand these products is exacerbated by marketing and promotional practices that emphasize potential benefits without also providing clear and balanced information about material risks.

In light of these considerations, communications with consumers, including advertisements, oral statements, promotional materials, and monthly statements, should provide clear and balanced information about the relative benefits and risks of these products, including the risks of payment shock and of negative amortization. Clear, balanced, and timely communication to consumers of the risks of these products will

provide consumers with useful information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make. Such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the institution.

## Legal Risks

Institutions that offer nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. With respect to the disclosures and other information provided to consumers, applicable laws and regulations include the following:

- Truth in Lending Act (TILA) and its implementing regulation, Regulation Z
- Section 5 of the Federal Trade Commission Act (FTC Act)

TILA and Regulation Z contain rules governing disclosures that institutions must provide for closed-end mortgages (1) in advertisements, (2) with an application,<sup>15</sup> (3) before loan consummation, and (4) when interest rates change. Section 5 of the FTC Act prohibits unfair or deceptive acts or practices.<sup>16</sup>

Other federal laws, including the fair-lending laws and the Real Estate Settlement Procedures Act (RESPA), also apply to these transactions. Moreover, the Federal Reserve notes that the sale or securitization of a loan may not affect an institution’s potential liability for violations of TILA, RESPA, the FTC Act, or other laws in connection with its origination of the loan. State laws, including laws regarding unfair or deceptive acts or practices, also may apply.

## Recommended Practices

Recommended practices for addressing the risks

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15. These program disclosures apply to ARM products and must be provided at the time an application is provided or before the consumer pays a nonrefundable fee, whichever is earlier.

16. The Board of Governors enforces this provision under the FTC Act and section 8 of the Federal Deposit Insurance Act. See the joint Board and FDIC guidance titled *Unfair or Deceptive Acts or Practices by State-Chartered Banks*, March 11, 2004.

raised by nontraditional mortgage products include the following:<sup>17</sup>

### Communications with Consumers

When promoting or describing nontraditional mortgage products, institutions should provide consumers with information that is designed to help them make informed decisions when selecting and using these products. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers. Thus, institutions should provide consumers with information at a time that will help consumers select products and choose among payment options. For example, institutions should offer clear and balanced product descriptions when (1) a consumer is shopping for a mortgage (such as when the consumer makes an inquiry to the institution about a mortgage product and receives information about nontraditional mortgage products) or (2) when marketing relating to nontraditional mortgage products is provided by the institution to the consumer. Clear and balanced information should not be offered by the institution only upon the submission of an application or at consummation.<sup>18</sup> The provision of such information would serve as an important supplement to the disclosures currently required under TILA and Regulation Z as well as other laws.<sup>19</sup>

#### *Promotional Materials and Product Descriptions*

To assist other consumers in their product selec-

17. Institutions should review the recommendations relating to mortgage lending practices set forth in other supervisory guidance from their respective primary regulators, as applicable, including guidance on abusive lending practices.

18. Institutions also should strive to (1) focus on information important to consumer decision making; (2) highlight key information to make it more prominent; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers who are considering the nontraditional mortgage products and other loan features described in this guidance.

19. Institutions may not be able to incorporate all of the practices recommended in this guidance when advertising nontraditional mortgages through certain forms of media, such as radio, television, or billboards. Nevertheless, institutions should provide clear and balanced information about the risks of these products in all forms of advertising.

tion decisions, promotional materials and other product descriptions should provide information about the costs, terms, features, and risks of nontraditional mortgages (including information about the matters discussed below).

*Payment Shock.* Institutions should apprise consumers of potential increases in payment obligations for these products, including circumstances in which interest rates or negative amortization reach a contractual limit. For example, product descriptions could state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached.<sup>20</sup> Such information also could describe when structural payment changes will occur (for example, when introductory rates expire or when amortizing payments are required) and what the new payment amount would be or how it would be calculated. As applicable, these descriptions could indicate that a higher payment may be required at other points in time due to factors such as negative amortization or increases in the interest-rate index.

*Negative Amortization.* When negative amortization is possible under the terms of a nontraditional mortgage product, consumers should be apprised of the potential for increasing principal balances and decreasing home equity, as well as other potential adverse consequences of negative amortization. For example, product descriptions should disclose the effect of negative amortization on loan balances and home equity, and could describe the potential consequences to the consumer of making minimum payments that cause the loan to negatively amortize. (One possible consequence is that it could be more difficult to refinance the loan or to obtain cash upon a sale of the home.)

*Prepayment Penalties.* If the institution may impose a penalty in the event that the consumer prepays the mortgage, consumers should be alerted to this fact and to the need to ask the lender about the amount of any such penalty.

*Cost of Reduced Documentation Loans.* If an institution offers both reduced and full documen-

20. Consumers also should be apprised of other material changes in payment obligations, such as balloon payments.

tation loan programs and there is a pricing premium attached to the reduced documentation program, consumers should be alerted to this fact.

*Monthly Statements on Payment-Option ARMs.* Monthly statements that are provided to consumers on payment-option ARMs should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that making this payment would result in an increase to the consumer's outstanding loan balance. Payment statements also could provide the consumer's current loan balance, what portion of the consumer's previous payment was allocated to principal and to interest, and, if applicable, the amount by which the principal balance increased. Institutions should avoid leading payment-option ARM borrowers to select a nonamortizing or negatively amortizing payment (for example, through the format or content of monthly statements).

*Practices to Avoid.* Institutions also should avoid practices that obscure significant risks to the consumer. For example, if an institution advertises or promotes a nontraditional mortgage by emphasizing the comparatively lower initial payments permitted for these loans, the institution also should provide clear and comparably prominent information alerting the consumer to the risks. Such information should explain, as relevant, that these payment amounts will increase, that a balloon payment may be due, and that the loan balance will not decrease and may even increase due to the deferral of interest or principal payments. Similarly, institutions should avoid promoting payment patterns that are structurally unlikely to occur.<sup>21</sup> Such practices could raise legal and other risks for institutions, as described more fully above.

Institutions also should avoid such practices as (1) giving consumers unwarranted assurances

or predictions about the future direction of interest rates (and, consequently, the borrower's future obligations); (2) making one-sided representations about the cash savings or expanded buying power to be realized from nontraditional mortgage products in comparison with amortizing mortgages; (3) suggesting that initial minimum payments in a payment-option ARM will cover accrued interest (or principal and interest) charges; and (4) making misleading claims that interest rates or payment obligations for these products are "fixed."

## Control Systems

Institutions should develop and use strong control systems to monitor whether actual practices are consistent with their policies and procedures relating to nontraditional mortgage products. Institutions should design control systems to address compliance and consumer information concerns as well as the safety and soundness considerations discussed in this guidance. Lending personnel should be trained so that they are able to convey information to consumers about product terms and risks in a timely, accurate, and balanced manner. As products evolve and new products are introduced, lending personnel should receive additional training, as necessary. Lending personnel should be monitored to determine whether they are following these policies and procedures. Institutions should review consumer complaints to identify potential compliance, reputation, and other risks. Attention should be paid to appropriate legal review and to using compensation programs that do not improperly encourage lending personnel to direct consumers to particular products.

With respect to nontraditional mortgage loans that an institution makes, purchases, or services using a third party, such as a mortgage broker, correspondent, or other intermediary, the institution should take appropriate steps to mitigate risks relating to compliance and consumer information concerns discussed in this guidance. These steps would ordinarily include, among other things, (1) conducting due diligence and establishing other criteria for entering into and maintaining relationships with such third parties, (2) establishing criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this guidance, (3) setting requirements for agree-

21. For example, marketing materials for payment-option ARMs may promote low predictable payments until the recast date. Such marketing should be avoided in circumstances in which the minimum payments are so low that negative amortization caps would be reached and higher payment obligations would be triggered before the scheduled recast, even if interest rates remain constant.

ments with such third parties, (4) establishing procedures and systems to monitor compliance with applicable agreements, bank policies, and laws, and (5) implementing appropriate corrective actions in the event that the third party fails to comply with applicable agreements, bank policies, or laws.

## APPENDIX (Terms Used in This Document)

*Interest-Only Mortgage Loan.* An interest-only mortgage loan refers to a nontraditional mortgage in which, for a specified number of years (for example, three or five years), the borrower is required to pay only the interest due on the loan, during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or it may fluctuate based on the prescribed index and payments, including both principal and interest.

*Payment-Option ARM.* A payment-option ARM is a nontraditional adjustable-rate mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a “start” or introductory interest rate, an interest-

only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15- or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

*Reduced Documentation.* Reduced documentation is a loan feature that is commonly referred to as “low doc/no doc,” “no income/no asset,” “stated income,” or “stated assets.” For mortgage loans with this feature, an institution sets reduced or minimal documentation standards to substantiate the borrower’s income and assets.

*Simultaneous Second-Lien Loan.* A simultaneous second-lien loan is a lending arrangement where either a closed-end second lien or a home equity line of credit is originated simultaneously with the first-lien mortgage loan, typically in lieu of a higher down payment.



# Nontraditional Mortgages—Associated Risks Examination Objectives

Effective date May 2007

Section 2043.2

1. To ascertain if the bank has adequate risk-management processes, policies, and procedures to address the risk associated with its nontraditional mortgage loans.
2. To evaluate whether the bank's nontraditional mortgage loan terms are supported by a disciplined analysis of its potential exposures versus the mitigating factors that ensure that risk levels are adequately managed.
3. To determine if the underwriting standards for nontraditional mortgage loans comply with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines.
4. To evaluate whether the bank's management carefully considers and appropriately assesses and mitigates the risk exposures created by the nontraditional mortgage loans by ensuring that—
  - a. its loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity;
- b. its nontraditional mortgage loan products have strong risk-management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses that reflects the collectibility of the portfolio; and
- c. its consumers have sufficient information to clearly understand the loan terms and associated risks prior to making a nontraditional mortgage loan product choice.
5. To determine if the bank has borrower qualification criteria that include an evaluation of a borrower's repayment capacity and ability to repay the debt—the full amount of the credit extended, including any balance increase that may accrue from negative amortization—by the final maturity date at the fully indexed rate.

# Nontraditional Mortgages—Associated Risks Examination Procedures

Effective date May 2007

Section 2043.3

## RISK MITIGATION

1. Assess the bank's management procedures to mitigate the risk created by nontraditional mortgage products. Determine that—
  - a. underwriting standards and terms are consistent with prudent lending practices, including consideration of each borrower's repayment capacity;
  - b. products are supported by strong risk-management standards, capital levels that are commensurate with their risk, and an allowance for loan and lease losses that reflects the collectibility of the portfolio; and
  - c. borrowers have sufficient information to clearly understand the terms of their loans and their associates risks.
4. Determine whether originated or purchased mortgage loans that combine nontraditional features (such as interest-only loans with reduced documentation and second-lien loans) have mitigating factors (that is, higher credit scores, lower LTVs and DTI repayment ratios, significant liquid assets, mortgage insurance, or other credit enhancements) that support the underwriting decisions and the borrower's repayment capacities.
5. Verify that the bank has clear loan underwriting policies governing the use of—
  - a. reduced documentation of the borrower's financial capacity (for example, non-verification of reported income when the borrower's income can be documented based on recent W-2 statements, pay stubs, or tax returns);
  - b. minimal or no owner's equity for second-lien home equity lines of credit (such loans generally should not have a payment structure allowing for delayed or negative amortization without other significant risk-mitigating factors);
  - c. introductory interest rates (banks should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates);
  - d. subprime lending (adherence to the inter-agency guidance on subprime lending);<sup>1</sup> and
  - e. non-owner-occupied investor loans (qualifications should be based on the borrower's ability to service the debt over the life of the loan, which would include a combined LTV ratio that considers negative amortization and sufficient borrower equity, and continuing cash reserves).

## UNDERWRITING STANDARDS

1. Determine if the bank's underwriting standards—
  - a. address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins,
  - b. comply with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines, and
  - c. require that loan terms are based on a disciplined analysis of potential exposures and mitigating factors, which will ensure that risk levels remain manageable.
2. Verify that the bank's nontraditional mortgage loan qualification standards recognize the potential impact of payment shock (particularly for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores).
3. Ascertain that the analysis of a borrower's repayment capacity includes—
  - a. an evaluation of the borrower's ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule,
  - b. a repayment schedule that is based on the initial loan amount plus any balance increase that may accrue from a negative amortization provision, and
  - c. avoiding an overreliance on credit scores

## PORTFOLIO AND RISK-MANAGEMENT PRACTICES

1. If the bank originates or invests in nontraditional mortgage loans, determine if more

<sup>1</sup> See SR-01-4 and SR-99-6.



robust risk-management practices have been adopted to manage the exposures.

- a. Verify that there are appropriate written lending policies that have been adopted and are being used and monitored, specifying acceptable product attributes, production and portfolio limits (growth and volume limits by loan type), sales and securitization practices, and risk-management expectations (acceptable levels of risk).
  - b. Determine if enhanced performance measures have been designed and if there is management reporting that provides an early warning for increasing risk.
  - c. Find out if the appropriate levels for the allowance for loan and lease losses (ALLL) have been established that consider the credit quality of the portfolio and the conditions that affect collectibility.
  - d. Evaluate whether adequate capital is maintained at levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility.
  - e. Determine if capital is held commensurate with the risk characteristics of the bank's nontraditional mortgage loan portfolios.
2. If the bank has concentrations in nontraditional mortgage products, determine if there are—
    - a. well-developed monitoring systems and risk-management practices that monitor and keep track of concentrations in key portfolio segments, such as by loan type, third-party originations, geographic area, and property occupancy status, and
    - b. systems that also monitor key portfolio characteristics: non-owner-occupied investor loans and loans with (1) high combined LTV ratios, (2) high DTI ratios, (3) the potential for negative amortization, (4) credit scores of borrowers that are below established thresholds, and (5) risk-layered features.
  3. Determine if the bank has adequate quality controls as well as compliance and audit procedures that focus on mortgage lending activities posing high risk.
    - a. Determine if the bank has strong internal controls over accruals, customer service, and collections.
    - b. Verify that policy exceptions made by servicing and collections personnel are carefully monitored and that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk.
  - c. Find out if the quality control function regularly reviews (1) a sample of nontraditional mortgage loans from all origination channels and (2) a representative sample of underwriters confirming that underwriting policies are followed.
4. Bank oversight of third-party originators—
    - a. determine if the bank has strong systems and controls in place for establishing and maintaining relationships with third-party nontraditional mortgage loan originators, including procedures for due diligence, and
    - b. find out if the oversight of third-party mortgage loan origination lending practices includes monitoring the quality of originations (that is, the quality of origination sources, key borrower characteristics, appraisals, loan documentations, and credit repayment histories) so that they are reflective of the bank's lending standards and in compliance with applicable laws and regulations.
  5. Determine if the bank's risk-management practices are commensurate with the nature, volume, and risk of its secondary-market activities.
    - a. Find out if there are comprehensive formal strategies for managing the risks arising from significant secondary-market activities.
    - b. Ascertain if contingency planning includes how the bank will respond to a decline in loan demand in the secondary market.
    - c. Determine if there were any repurchases of defaulted mortgages and if the bank complies with its risk-based capital guidelines.
  6. Evaluate the appropriateness of management information and reporting systems for the level and nature of the bank's mortgage lending activity.
    - a. Verify that the reporting allows management to detect changes in the risk profile, or deteriorating performance, of its nontraditional mortgage loan portfolio.
    - b. Determine if management information is reported and available by loan type, risk-layering features, underwriting characteristics, and borrower performance.
    - c. Find out if—
      - 1) portfolio volume and performance are

- tracked against expectations, internal lending standards, and policy limits;
- 2) volume and performance expectations are established at the subportfolio and aggregate portfolio levels;
  - 3) variance analyses are regularly performed to identify exceptions to policies and prescribed thresholds; and
  - 4) qualitative analyses are performed when actual performance deviates from established policies and thresholds.
- d. Determine if the bank, based on the size and complexity of its lending operations, performs sensitivity analysis on its key portfolio segments to identify and quantify events that may increase its risks in a segment or the entire portfolio.
  - e. Verify that the scope of the sensitivity analysis includes stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the bank's immediate control.
  - f. Find out if the stress testing results provide direct feedback for determining underwriting standards, product terms, portfolio concentration limits, and capital levels.
  - g. Determine if the bank has established an appropriate ALLL for the estimated credit losses and commensurate capital levels for the risk inherent in its nontraditional mortgage loan portfolios (considering the higher risk of loss posed by the layered risks).
  - h. If the bank has material mortgage banking activities and mortgage servicing assets—
    - a. evaluate whether sound practices were applied in valuing the mortgage servicing rights for its nontraditional mortgages and
    - b. ascertain if the valuation process followed the nontraditional mortgage and other interagency guidance and generally accepted accounting principles, and whether reasonable and supportable assumptions were used.

# Nontraditional Mortgages—Associated Risks Internal Control Questionnaire

Effective date May 2007

Section 2043.4

Review the bank's internal controls, policies, procedures, and practices for making and servicing nontraditional mortgage loans. The bank's internal control system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

## RISK MANAGEMENT AND RISK MITIGATION

1. Are there procedures established to control, limit, and monitor the authorization of nontraditional mortgage loan transactions and to establish the appropriate supervision and preliminary review of nontraditional mortgage loan decisions?
2. For nontraditional mortgage loans, is there an appropriate separation of the employees' duties involving (1) the authorizing, executing, recording, and adjusting of loans, (2) receiving payments, (3) reconciling the accounts, and (4) maintaining clear title to, and custody of, pledged collateral—all to safeguard against the possible misappropriation of the bank's funds?
3. Has the bank's management developed risk-mitigation procedures for nontraditional mortgage products? If so, do the risk-mitigation procedures—
  - a. set forth underwriting standards and terms that are consistent with prudent lending practices, including the consideration of each borrower's repayment capacity, third-party credit reports, pledged collateral valuations, and regularly timed follow-up reviews thereon?
  - b. require that nontraditional mortgage products be supported by appropriate supervisory oversight and review, strong risk-management standards, capital levels that are commensurate with their risk, and an adequate allowance for loan and lease losses (ALLL) that reflects the collectibility of the portfolio?
  - c. require that borrowers be provided with sufficient information so they can clearly understand the terms of their loans and their associated risks?

## UNDERWRITING STANDARDS

1. Do the bank's underwriting standards—
  - a. appropriately address and assess the effect of a substantial payment increase in the borrower's capacity to repay when loan amortization begins?
  - b. establish practices consistent with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines?
  - c. require that loan terms be based on a disciplined analysis of potential exposures and mitigating factors, which will ensure that risk levels will remain manageable?
2. Does the bank's nontraditional mortgage loan qualification standards recognize the potential impact of payment shock, particularly for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores?
3. Does the analysis of a borrower's repayment capacity include—
  - a. an evaluation of the borrower's ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule?
  - b. a repayment schedule that is based on the initial loan amount plus any balance increase that may accrue from a negative amortization provision?
  - c. an avoidance of overreliance on credit scores as a substitute for income verification or reliance on the sale or refinancing of the property when amortization begins?
4. Do originated or purchased mortgage loans that combine nontraditional features (such as interest-only loans with reduced documentation and second-lien loans) have mitigating factors (that is, higher credit scores, lower LTVs and DTI repayment ratios, significant liquid assets, mortgage insurance, or other credit enhancements) that support the underwriting decisions and the borrower's repayment capacities?
5. Are there clear bank loan underwriting policies governing the use of—
  - a. reduced documentation of the borrower's financial capacity (for example, non-

- verification of reported income when the borrower's income can be documented based on recent W-2 statements, pay stubs, or tax returns)?
- b. minimal or no owner's equity for second-lien home equity lines of credit (such loans generally should not have a payment structure allowing for delayed or negative amortization without other significant risk-mitigating factors)?
  - c. introductory interest rates (banks should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates)?
  - d. subprime lending (including underwriting policies that are consistent with the interagency guidance on subprime lending)<sup>1</sup>?
  - e. non-owner-occupied investor loans (the qualifications should be based on the borrower's ability to service the debt over the life of the loan, which would include a combined LTV ratio that would consider negative amortization and sufficient borrower equity, and continuing cash reserves)?
2. If the bank has concentrations in nontraditional mortgage products, are there—
    - a. well-developed monitoring systems and risk-management practices that monitor and keep track of concentrations in key portfolio segments, such as by loan type, third-party originations, geographic area, and property occupancy status?
    - b. systems that also monitor key portfolio characteristics: non-owner-occupied investor loans and loans with (1) high combined LTV ratios, (2) high DTI ratios, (3) the potential for negative amortization, (4) credit scores of borrowers that are below established thresholds, and (5) risk-layered features?
  3. Does the bank have adequate quality controls, including an independent internal loan review staff, that will consider and review loan documentation and other compliance and audit procedures that focus on mortgage lending activities posing high risk? Are there—
    - a. strong internal controls over accruals, customer service, and collections?
    - b. reviews of policy exceptions, conducted by servicing and collections personnel, which are carefully monitored, and are practices such as re-aging, payment deferrals, and loan modifications regularly reviewed to ensure that they are not inadvertently increasing risk?
    - c. regular reviews conducted by the quality control function that focus on (1) a sample of nontraditional mortgage loans from all origination channels and (2) a representative sample of underwriters to confirm that underwriting policies are followed?
  4. Bank oversight of third-party originators—
    - a. Does the bank have strong internal systems and controls in place for establishing and maintaining relationships with third-party nontraditional mortgage loan originators, including procedures for due diligence?

## PORTFOLIO AND RISK-MANAGEMENT PRACTICES

1. If the bank originates or invests in nontraditional mortgage loans—
  - a. has the bank adopted risk-management practices to keep pace with the growth and changing risk profile of its nontraditional loan portfolio?
  - b. are there appropriate bank-adopted (and monitored) written lending policies in use that specify—
    - acceptable product attributes?
    - production and portfolio limits (growth and volume limits by loan type)?
    - sales and securitization practices?
    - risk-management expectations (acceptable levels of risk)?
  - c. have enhanced performance measures been designed and is there management reporting that will provide an early warning of increasing risk?
  - d. are there appropriate ALLL levels estab-

1. See SR-01-4 and SR-99-6.

- b. Are there staff designated to provide bank oversight of third-party mortgage loan origination lending practices, which include the monitoring of the quality of originations (that is, the quality of origination sources, key borrower characteristics, appraisals, loan documentations, and credit repayment histories) to ensure that the originations (1) reflect adherence to the bank's lending standards and (2) compliance with applicable laws and regulations?
5. Are the bank's risk-management practices for nontraditional mortgage loans commensurate with the nature, volume, and risk of its secondary-market activities? If so, are there—
  - a. comprehensive formal strategies for managing the risks arising from significant secondary-market activities?
  - b. bank contingency plans that include how the bank will respond to a decline in loan demand in the secondary market?
  - c. repurchases of defaulted mortgages and, if so, is the bank in compliance with its riskbased capital guidelines?
- d. qualitative analyses performed when actual performance deviates from established policies and thresholds?
5. Does the bank's MIS provide reports consisting of a trial balance of the borrower's loan balances, and an aged trial balance (based on the borrower's loan repayment terms), for the entire loan portfolio (the totals of which agree with the bank's respective general ledger balance[s]), but with nontraditional mortgage loan balances segregated and subtotaled (or totaled)?
6. Does the bank, based on the size and complexity of its lending operations, perform sensitivity analysis on its key portfolio segments to identify and quantify events that may increase its risks in a segment or the entire portfolio?
7. Does the scope of the sensitivity analysis include stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the bank's immediate control?
8. Do the stress testing results provide direct feedback for determining underwriting standards, product terms, portfolio concentration limits, and capital levels?
9. Has the bank established and maintained an appropriate ALLL for the estimated credit losses on nontraditional mortgage loans?
10. Do designated supervisory personnel periodically review adjustments to, and of, past due and charged-off nontraditional mortgage loans to confirm that appropriate actions have been taken, including collections and recoveries?
11. Does the bank have commensurate capital levels for the risk inherent in its nontraditional mortgage loan portfolios (considering the higher risk of loss posed by the layered risks)?
12. If the bank has material mortgage banking activities and mortgage servicing assets—
  - a. has it evaluated whether sound practices were applied in valuing the mortgage servicing rights for its nontraditional mortgages?
  - b. does the bank's valuation process follow the nontraditional mortgage and other interagency guidance and generally accepted accounting principles, and have reasonable and supportable assumptions been used?

## MANAGEMENT INFORMATION SYSTEM

1. Are the bank's management information system (MIS) and reports appropriate for the level and nature of the bank's nontraditional mortgage lending activity?
2. Do the systems and reports allow management to detect changes in the risk profile of, or deteriorating performance in, its nontraditional mortgage loan portfolio?
3. For the bank's nontraditional loan portfolio, is management information reported and available by loan type, risk-layering features, underwriting characteristics, and borrower performance?
4. Is the bank's nontraditional mortgage portfolio's—
  - a. volume and performance tracked against expectations, internal lending standards, and policy limits?
  - b. volume and performance expectations established at the sub portfolio and aggregate portfolio levels?
  - c. variance analyses regularly performed to identify exceptions to policies and prescribed thresholds?

## CONCLUSION

1. With respect to the bank's management of its nontraditional mortgage loan portfolio, is there adequate separation of duties, proper authorization of transactions and activities, adequate documents and records, physical control over assets and records, and independent checks on performance?
2. Have any responses to the forgoing information revealed any significant deficiencies and weaknesses in the bank management's system of internal controls over its nontraditional mortgage loan portfolio—weaknesses that effect controls over risk management and assessment, the reliability of financial reporting, the accounting information and communication system, efficiency and effectiveness of operations, compliance with laws and regulations, and monitoring of internal control performance?
3. Are there any internal control deficiencies in areas that are not covered within this questionnaire that impair any controls? Explain any additional examination procedures that are, or would be, necessary to draw conclusions about the adequacy of the internal controls over the bank's nontraditional mortgage loans.
4. Based on an overall evaluation, as evidenced by your answers to the foregoing questions, are internal controls over the bank's nontraditional mortgage loans adequate or inadequate?

# Loan Participations, the Agreements and Participants

Effective date October 2009

## Section 2045.1

This section provides supervisory and accounting guidance for examiners to use in their examination and review of a bank's creation and use of loan participation agreements. Additional guidance, research, and information on loan participations and loan participation agreements will be developed and considered for future issuance and implementation.

A loan participation is an agreement that transfers a stated ownership interest in a loan to one or more other banks, groups of banks, or other entities. The transfer represents an ownership interest in an individual financial asset. The lead bank retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. Banks should ensure that comprehensive participation agreements with originating institutions are in place for each loan facility before they consider purchasing any participating interest.

Many banks purchase loans or participate in loans originated by others. In some cases, such transactions are conducted with affiliates, groups of banks, or members of a chain-banking organization. Alternatively, a purchasing bank may also wish to supplement its loan portfolio when loan demand is weak. In still other cases, a bank may purchase or participate in a loan to accommodate another unrelated bank with which it has established an ongoing business relationship.

Purchasing or selling loans, if done properly, can have a legitimate role in a bank's overall asset and liability management and can contribute to the efficient functioning of the financial system. In addition, these activities help a bank diversify its risks and improve its liquidity.

### BOARD POLICIES ON LOAN PARTICIPATIONS

Banks should have sufficient board-approved policies in place that govern their loan participation activities. At a minimum, the policy should include (1) the requirements for entering into a loan participation agreement, (2) limits for the aggregate amount of loans purchased from and sold to an outside source, (3) limits of all loans purchased and sold, (4) limits for the aggregate amount of loans to particular industries, (5) comprehensive participation agree-

ments with originating banks, (6) complete analysis and documentation of the credit quality of obligations purchased, (7) an analysis of the value and lien status of the collateral, (8) appraisal guidelines, (9) the maintenance of full independent credit information on the borrower throughout the term of the loan, (10) guidelines for the timely transfer of all financial and nonfinancial credit information to participant banks, and (11) collection procedures.

### LOAN PARTICIPATION AGREEMENT

A loan participation agreement may enable a smaller bank (the lead bank or transferor) to originate a large loan in excess of its legal lending limit. Participating banks that have an ownership interest are able to offset low local loan demand or invest in large loans without the burden of servicing the loan or incurring origination costs. A loan participation agreement may also allow the originating bank to facilitate and grant a larger loan without causing it to have a concentration of credit (i.e., enabling risk diversification) or an impairment of its liquidity position. The participation agreement should contain provisions that require the originating bank to transfer, in a timely manner, all financial and nonfinancial credit information to the participant banks upon the loan's origination and throughout the term of the loan. The agreement should specify the allocation of payments, losses, and expenses. It should also state that a participating bank has the right to perform its own independent review of the transaction. The agreement should contain no language indicating that the lead bank is a "lender" or that a participating bank is a "borrower." The purchase of loan participations without a comprehensive agreement could be viewed as an unsafe and unsound banking practice.

### ACCOUNTING FOR LOAN PARTICIPATIONS

A loan participation agreement is usually structured to allow the participation transaction to receive sale treatment of a portion of the loan by the originating bank even though the

participation agreement may restrict the purchaser when reselling its interest in the loan, subject to certain conditions.<sup>1</sup> Sale treatment is achieved by structuring the loan participation agreement so that interests sold to a purchaser meet the definition of a “participating interest” and the transaction satisfies all conditions for transfer of control over the interests. In general, FAS 166 (paragraph 8B) briefly defines a participating interest as a portion of a financial asset that

1. conveys proportionate ownership rights with equal priority to each participating interest holder.
2. involves no recourse (other than standard representations and warranties) to, or subordination by, any participating interest holder.
3. does not entitle any participating interest holder to receive cash before any other participating interest holder.

A transfer of a participating interest in an entire financial asset in which the transferor surrenders control over those interests is to be accounted for as a sale if and only if *all the following conditions* are met:

1. The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.<sup>2</sup>
2. Each purchaser has the right to pledge or exchange the interests it received, and no condition both constrains the purchaser from taking advantage of its right to pledge or

1. Three sale recognition conditions denote the transferor’s surrender of control under Financial Accounting Standards (FAS) 166, “Accounting for Transfers of Financial Assets” (an amendment of FAS 140). Those conditions must be met in order for the originator (transferor) to account for the transfer of the financial assets to the participating transferee as a sale. When a loan participation is accounted for as a sale, the seller (transferor) removes the participated interest in the loan from its financial statements. FAS 166 applies to both the transferor (seller) of the participated assets and the transferee (purchaser). (See the complete text of FAS 166 (paragraphs 8B and 9) that defines a “participating interest” and the conditions for sale recognition). See also the reporting instructions for the FFIEC Consolidated Reports of Condition and Income (FFIEC 031) (bank Call Report).

2. Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented.

exchange and provides more than a trivial benefit to the transferor.

3. The transferor does *not* maintain effective control over the interests.<sup>3</sup>

## STRUCTURING THE LOAN PARTICIPATION AGREEMENT

The written participation agreement should consider contingent events such as a defaulting borrower, the lead bank becoming insolvent, or a party to the participant arrangement that is not performing as expected. The agreement should clearly state the limitations the originator or participants impose on each other and any rights that the parties retain. The participation agreement should clearly include

- the obligation of the lead bank to furnish timely credit information and to notify the parties of significant changes in the borrower’s status;
- a requirement that the lead bank consult with the participants prior to any proposed change to the loan, guarantee, or security agreements, or taking any action when the borrower defaults;
- the lead bank’s and participants’ specific rights if the borrower defaults;
- the resolution procedures to be followed when the lead bank or participants
  - do not agree on the procedures to be taken when the borrower defaults and/or;
  - have potential conflicts when the borrower defaults on more than one loan;
- provisions for terminating the agency relationship between the lead bank and the participants upon events such as insolvency, breach of duty, negligence, or misappropriation by one of the parties to the agreement.

Some participation agreements may allocate

3. Examples of a transferor’s effective control over the transferred financial assets include (a) an agreement that both entitles and obligates the transferor to repurchase or redeem the financial asset (or its third-party beneficial interests) before its maturity, (b) an agreement that provides the transferor with both the unilateral ability to cause the holder to return specific financial assets and a more-than-trivial benefit attributable to that ability, other than through a cleanup call, or (c) an agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them.



payments using a method other than a pro rata sharing based on each participant's ownership interest. The first principal payment could be applied based on the participant's ownership interest while the remaining payments would be applied according to the lead bank's ownership interest. In this situation, the participation agreement should specify that if a borrower defaults, the participants would share subsequent payments and collections in proportion to their ownership interest at the time of default.<sup>4</sup>

A participation agreement may provide that the lead bank, as the originating lender, allow a participating bank to resell, but the lead bank reserves the right to call at any time from whoever holds the ownership interest. The lead bank can then enforce the call option by cutting off or restricting the flow of interest at the call date.<sup>5</sup> In this situation, the lead bank, as originating lender, has retained effective control over the participation; such a call option precludes sale accounting treatment by the transferor. The transaction, therefore, should be accounted for as a secured borrowing.

## INDEPENDENT CREDIT ANALYSIS

A bank that acquires a loan participation should regularly perform a rigorous credit analysis on its loan participation as if it had originated the loan. Due to the indirect relationship that a participating bank has with a borrower, it may be difficult for the participating bank to receive timely credit information to allow it to conduct a comprehensive credit analysis of the transaction. However, the participating bank should not rely solely on the lead bank's credit analysis. It should gather all available relevant credit information, including the details on the collateral's value (for example, values determined by an independent appraisal or an evaluation), lien status, loan agreements, and the loan's other participation agreements that existed prior to making its commitment to acquire the loan participation. A participating bank also should reach an agreement with the loan originator (transferor) that it will provide ongoing, complete, and timely credit information about the

borrower. It is important for the participating banks to maintain current and complete records on their loan participations. The absence of such information may indicate that the bank did not perform the necessary due diligence prior to making its decision to acquire the loan participation. During the life of the loan participation, the bank should monitor the loan's servicing and repayment status.

## SALES OF LOAN PARTICIPATIONS IN THE SECONDARY MARKET

If a bank has a concentration in loan participations, it may be possible for it to sell its participating interests in the secondary market to reduce its dependence on an asset group. If the bank is not large enough to participate in the secondary market, an alternative might be to sell loans without recourse to a correspondent bank that also desires to diversify its loan portfolio.

## SALE OF LOAN PARTICIPATIONS WITH OR WITHOUT THE RIGHT OF RECOURSE

The parties to a participation agreement (those having a participating ownership interest) generally may have *no recourse* to the transferor or to each other even though the transferor (e.g., the originating lender) continues to service the loan. No participant's interest should be subordinate to another. Some loan participation agreements, however, may give the seller a contractual right to repurchase the participated loan interest for purposes of working out or modifying the sale. When the seller has the right to repurchase the participation, it may provide the seller with a call option on a specific loan participation asset. If the seller's right to repurchase precludes the seller from recognizing the transaction as a sale, the transaction should be accounted for as a secured borrowing.

## SALES OF 100 PERCENT PARTICIPATIONS

Some loan participation agreements may be structured so that the transferor (lead bank) sells

4. This is *not* a participating interest—no sale.

5. The cash flows from a loan participation agreement, except servicing fees, should be divided in proportion to the third parties' participating interests.

the entire underlying loan amount (100 percent) to the agreement's participants. If participation agreements are not structured properly they can pose unnecessary and increased risks (for example, legal, compliance, or reputational risks) to the originator and the participants. The lead bank, as originator, would have no ownership in the loan. Such agreements should therefore clearly state that the loan participants are participating in the loan and that they are not investing in a business enterprise. The policies of a bank engaged in such loan participation agreements should focus on safety and soundness concerns that include

- the program's objectives
- the plan of distribution
- the credit requirements that pertain to the borrower—the originating bank should structure 100 percent loan participation programs only for borrowers who meet the originating institution's credit requirements
- the program participant's accessibility to the borrower's financial information (as authorized by the borrower)—the originating bank should allow potential loan participants to obtain and review appropriate credit and other information that would enable them to make an informed credit decision.

## PARTICIPATION TRANSACTIONS BETWEEN AFFILIATES

Banks should not relax their credit standards when participation agreements involve affiliated insured depository institutions. Such agreements must be structured to comply with sections 23A and 23B of the Federal Reserve Act (FRA) and the Board's Regulation W. The Federal Reserve has determined that in certain very limited circumstances the purchase or sale of a participation agreement may be exempt from these provisions.

### Transfer of Low-Quality Assets

In general, a bank cannot purchase a low-quality asset, including a loan participation from an affiliate. Section 23A of the FRA provides a limited exception to the general rule prohibiting purchase of low-quality assets if the bank performs an independent credit evaluation and

commits to the purchase of the asset before the affiliate acquires the asset.<sup>6</sup> Section 223.15 of the Board's Regulation W provides an exception from the prohibition on the purchase of a low-quality asset by a member bank from an affiliate for certain loan renewals. The rule allows a member bank that purchased a loan participation from an affiliate to renew its participation in the loan, or provide additional funding under the existing participation, even if the underlying loan had become a low-quality asset, so long as certain criteria were met. These renewals or additional credit extensions may enable both the affiliate and the participating member bank to avoid or minimize potential losses. The exception is available only if (1) the underlying loan was not a low-quality asset at the time the member bank purchased its participation and (2) the proposed transaction would not increase the member bank's proportional share of the credit facility. The member bank must also obtain the prior approval of its entire board of directors (or its delegees) and it must give a 20-day post-consummation notice to its appropriate federal banking agency. A member bank is permitted to increase its proportionate share in a restructured loan by 5 percent (or by a higher percentage with the prior approval of the bank's appropriate federal banking agency). The scope of the exemption includes renewals of participations in loans originated by any affiliate of the member bank (not just affiliated depository institutions).

## CONCENTRATIONS OF CREDIT INVOLVING LOAN PARTICIPATIONS

Banks should avoid purchasing loans that generate unacceptable credit concentrations. Such concentrations may arise solely from the bank's purchases, or they may arise when loans or purchased participations are aggregated with loans originated and retained by the purchasing bank. The extent of contingent liabilities, holdbacks, reserve requirements, and the manner in which loans will be handled and serviced should be clearly defined. In addition, loans purchased from another source should be evaluated in the same manner as loans originated by the bank itself. Guidelines should be established for the

<sup>6</sup> 12 USC 371c(a)(3).

type and frequency of credit and other information the bank needs to obtain from the originating institution to keep itself continually updated on the status of the credit. Guidelines should also be established for supplying complete and regularly updated credit information to the purchasers of loans originated and sold by the bank.

## LOAN PARTICIPATIONS AND ENVIRONMENTAL LIABILITY

Environmental risk represents the adverse consequences that result from generating or handling hazardous substances or from being associated with the aftermath of contamination. Banks may be indirectly liable via their lending activities for the costs resulting from cleaning up hazardous substance contamination. Banks need to be careful that their actions making, administering, and collecting loans—including assessing and controlling environmental liability—cannot be construed as taking an active role in the management or day-to-day operations of a borrower's business. Such actions could lead to potential liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA). Banks that originate loans to borrowers through loan participation agreements could be transferring environmental risk and liability to the holders of participations, thus making them susceptible to such losses. The originating banks should establish and follow policies and procedures designed to control environmental risks. See section 2140.1 (the "Environmental Liability" subsection)

for a more detailed discussion on ways banks can protect themselves as lenders, and their loan participation agreement holders, from environmental liability.

## RED FLAG WARNING SIGNALS

The following conditions may indicate that there are significant problems with the management of the bank's loan participation portfolio:

1. the absence of formal loan participation policies.
2. the absence of any formal participation agreement.
3. the absence of credit evaluations and independent credit analysis.
4. the absence of complete loan documentation.
5. a higher volume of loan participations when compared to the volume of other loans in the bank's loan portfolio.
6. missing loan participation agreements and documentation which should denote the rights and responsibilities of all participants.
7. the existence of numerous disputes or disagreements among the participants regarding
  - a. the receipt of payment(s) in accordance with the participation agreements,
  - b. documentation requirements, or
  - c. any other significant aspects of the bank's loan participation transactions.
8. the originating bank is making loan payments to loan participation acquirers without receiving reimbursement by the original borrower.

# Loan Participations Examination Objectives

Effective date October 2009

## Section 2045.2

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1. To ascertain if the bank engages in the purchase or sale of loans via loan participation agreements.
2. To determine if the bank's lending policy
  - a. places limits on the amount of loan participations originated, purchased, or sold based on any one source or in the aggregate;
  - b. has set credit standards for the bank's borrowers requesting loans as well as third parties acquiring loan participations from the bank as originator;
  - c. requires the same credit standards for loan participations as it does for other loans;
  - d. sets the amount of contingent liability, holdback (retained ownership), and the manner in which the loan should be serviced; or
  - e. requires complete loan documentation for loan participations.
3. To assess the impact of any concentrations of credit to a borrower, or in the aggregate, that arise from loans involved in loan participation agreements.
4. To determine if there are any informal repurchase agreements that exist between loan participation acquirers that are designed to circumvent the originating bank's legal lending limits, disguise delinquencies, and avoid adverse classifications.
5. To determine whether the bank's financial condition is compromised by assessing the impact of the bank's loan participations with its affiliates.
6. To ascertain whether the bank's loan participation transactions with affiliates are in compliance with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.
7. To determine if there are disputes between the bank as originator of loan participations and its participants. To determine, if possible, if any loan participations have been adversely classified by examiners, including examiners from other supervisory agencies (includes loan participations held by the other institutions).

# Loan Participations Examination Procedures

Effective date October 2009

## Section 2045.3

These examination procedures are designed to ensure that originated loans that were transferred via loan participation agreements or certificates to state member banks, bank holding companies, nonbank affiliates, or other third parties were carefully evaluated. The examination procedures also instruct examiners to determine if the asset transfers were carried out to avoid or circumvent classification and to determine the effect of the transfers on the bank's financial condition. In addition, the procedures are designed to ensure that the primary regulator of another financial institution involved in the asset transfer is notified.

1. Review the board of directors' or their designated committees' policies and procedures governing how loan participation agreements and activities are created, transacted, and administered. Refer to section 2045.1 for the minimum items that should be included in board-approved policies on loan participation activities.
2. Determine if managerial reports provide sufficient information relative to the size and risk profile of the loan participation portfolio and evaluate the accuracy and timeliness of reports produced for the board and senior management.
3. For loan participations held (either in whole or in part) with another lending institution, review, if applicable,
  - participation certificates and agreements, on a test basis, to determine if the contractual terms are being adhered to;
  - loan documentation to determine if it meets the bank's underwriting procedures (that is, the documentation for loan participations should meet the same standards as the documentation for other loans the bank originates);
  - the transfer of loans immediately before the date of the examination to determine if the loan was either nonperforming or classified and if the transfer was made to avoid possible criticism during the current examination; and
  - losses to determine if they are shared on a pro rata or other basis according to the terms of the participation agreement.
4. Check participation certificates or agreements and records to determine whether the parties share in the risks and contractual payments on a pro rata or other basis.
5. Determine if loans are purchased on a recourse basis and that loans are sold on a nonrecourse basis.
6. Ascertain that the bank does not buy back or pay interest on defaulted loans in contradiction of the underlying participation agreement.
7. Compare the volume of outstanding originated or purchased loans that were issued in the form of loan participations with the total outstanding loan portfolio.
8. Determine if the bank has sufficient expertise to properly evaluate the volume of loans originated or purchased and sold as loan participations.
9. Based on the terms of the loan participation agreements, review the originator's distribution of the borrower's payments received to those entities or persons owning interests in the loan participations. Ascertain if the agreement's recourse provisions may require accounting for the transactions as a secured borrowing rather than as a sale.
10. Determine if loans are sold primarily to accommodate credit overline needs of customers or to generate fee income.
11. Determine if loans are purchased or sold to affiliates or other companies in a chain-banking organization or a commonly owned group of banks; if so, determine whether the purchasing companies are given sufficient information to properly evaluate the credit. (Section 23A of the Federal Reserve Act and the Board's Regulation W prohibit transfers of low-quality assets between affiliates. See section 4050.1, "Bank-Related Organizations.")
12. Investigate any situations in which assets were transferred before the date of examination:
  - a. Determine if any were transferred to avoid possible criticism during the examination.
  - b. Determine whether any of the loan participations transferred were nonperforming at the time of transfer, classified during the previous examination, or transferred for any other reason that may

- cause the loans to be considered of questionable quality.
13. Review the bank's policies and procedures to determine whether loan participations purchased by the bank are required to be given an independent, complete, and adequate credit evaluation. If the bank is a holding company subsidiary or a member of a chain-banking organization or commonly owned group of banks, review asset participations sold to affiliates or other known members of the chain or group of banks to determine if the asset purchases were supported by an *arm's-length* and *independent* credit evaluation.
  14. Determine that any assets purchased by the bank were properly reflected on its books at fair market value at the time of purchase.
  15. Determine that transactions involving transfers of low-quality assets to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and the holding company affiliate.
  16. If poor-quality assets were transferred to another financial institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank's appropriate staff will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable,
    - name of originating and receiving institutions;
    - type of assets involved;
    - date (or dates) of transfer;
    - total number and dollar amount of assets transferred;
    - status of the assets when transferred (e.g., nonperforming, classified, etc.); and
    - any other information that would be helpful to the other regulator. Ascertain whether the bank manages not only the risk from individual participation loans but also portfolio risk.
  17. Find out if management develops appropriate strategies for managing concentration levels, including the development of a contingency plan to reduce or mitigate concentrations during adverse market conditions (such a plan may include strategies involving not only loan participations, but also whole loan sales). Find out if the bank's contingency plan includes selling loans as loan participations.
  18. Ascertain if management periodically assesses the marketability of its loan participation portfolio and evaluates the bank's ability to access the secondary market.
  19. Verify whether the bank compares its underwriting standards for loan participations with those that exist in the secondary market.

# Loan Participations Internal Control Questionnaire

Effective date October 2009

## Section 2045.4

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1. Under what circumstances are loans participated?
2. Who determines the type of loans that may be participated? Does the bank have policies in that regard? Are credit standards included in the lending policy for purchased loan participations, and does the policy require complete loan documentation and independent credit and collateral evaluation or appraisal?
3. Does the lending policy place lending limits on the amount of loan participations purchased from any one source, and does it place an aggregate limit on such loans?
4. Are low-quality loans allowed to be participated?
5. What is the volume and frequency of inter-institution transactions involving loan participations?
6. Does the bank have accounting policies to ensure the appropriate treatment of loan participations as either sales or secured borrowings?

The guidance<sup>1</sup> discussed below highlights generally the accounting and reporting requirements unique to business combinations resulting in bargain purchase gains. The guidance does not provide a comprehensive discussion on all aspects of accounting for business combinations. (See SR-10-12 and its attachment.)

### SUPERVISORY CONSIDERATIONS

#### Compliance with GAAP and Regulatory Reporting Requirements

Accurate regulatory reports are critical for effective supervision and, because of their public availability, for enhancing the transparency of an institution's risk profile and financial position. Business combinations, including bargain purchase transactions and assisted transactions, should be accounted for in accordance with the Financial Accounting Standards Board's Accounting Standards Codification (ASC) Topic 805, "Business Combinations." The management of an acquiring institution is responsible for preparing regulatory reports in accordance with generally accepted accounting principles (GAAP), regulatory reporting requirements, and relevant supervisory guidance. The complexity of the accounting requirements related to a business combination does not relieve management of this responsibility and should be factored into management's overall analysis of the practicability of a potential acquisition. The management of each institution is responsible for establishing and maintaining appropriate governance and an effective internal control structure over the preparation of regulatory reports commensurate with the institution's size, complexity, and risk profile. This structure should include written policies and procedures that provide clear guidelines on accounting and reporting matters related to business combinations. Management is encouraged to discuss applicable regulatory reporting requirements and

supervisory considerations with its primary federal regulator prior to consummating a business combination.

#### Fair-Value Measurements

The valuation of the assets acquired and liabilities assumed in a business combination presents accounting and supervisory challenges. For example, many of these assets and liabilities are illiquid and lack quoted market prices, which complicates the estimation of their acquisition-date fair values. Thus, a key issue underlying fair-value estimates is the appropriateness of inputs and the appropriate selection and use of valuation techniques. Some valuation techniques employ complex models and, therefore, warrant further supervisory review. For example, reliability concerns may arise when the institution does not use clear and rigorous valuation techniques or where one or more significant inputs to a valuation estimate are not observable, even indirectly, from active markets. This is especially true when estimating the fair value of illiquid financial instruments, indemnification assets, and identifiable intangible assets that are acquired in a business combination.

It is management's responsibility to report fair values in accordance with ASC Topic 820, "Fair Value Measurement." Because of the significant impact fair-value measurements and any resultant goodwill or bargain purchase gain have on the financial statements, management should have appropriate written fair-value measurement policies, procedures, and controls in place. These policies, procedures, and controls should be executed by experienced and qualified individuals knowledgeable in both GAAP and regulatory reporting requirements for business combinations. Furthermore, management's fair-value measurements should be well supported and are subject to review by examiners.

If management does not possess the expertise to identify and measure the identifiable assets acquired and the liabilities assumed in a business combination (and the equity or member interests in the acquiree in a combination of mutual institutions), management should engage a qualified third-party expert to provide professional guidance and support for the preparation

1. Part III of the June 7, 2010, "Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions" was issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the former Office of Thrift Supervision.



of fair-value measurements required by ASC Topic 805 and determined in accordance with ASC Topic 820. For example, management may use a third party to estimate the expected cash flows and the fair value of a loan portfolio acquired in an assisted acquisition (and the related expected cash flows and fair value of an FDIC loss-sharing indemnification asset). The use of outside resources, however, does not relieve management of its responsibility to ensure that fair-value estimates are measured in accordance with GAAP. Management must sufficiently understand the bases for the measurement and valuation techniques used by outside parties to determine the appropriateness of these techniques, the underlying inputs and assumptions, and the resulting fair-value measurements.

### Retrospective Adjustments of Fair-Value Measurements during the Measurement Period

During the measurement period, management should finalize its fair-value measurement estimates and retrospectively adjust the provision-

ally recorded amounts to reflect the information it was seeking about the acquisition-date facts and circumstances promptly after receipt of this information. The existence of a measurement period does not permit management to delay completion of comprehensive fair-value measurements that conform to the requirements of ASC Topic 820. Rather, at the earliest possible reporting date, management should establish and report appropriate fair-value estimates for the identifiable assets acquired and liabilities assumed in a business combination (and the equity or member interests in the acquiree in a combination of mutual institutions).

An acquiring institution's regulatory capital is subject to retrospective adjustments made during the measurement period. Although bargain purchase gains are reported in earnings and included in the computation of regulatory capital under the agencies' capital standards, the acquiring institution's primary federal regulator may determine an estimated bargain purchase gain lacks sufficient necessary permanence to rely on the estimate as a component of regulatory capital.

### INTRODUCTION

A concentration of credit generally consists of direct or indirect (1) extensions of credit and (2) contingent obligations that, when aggregated, exceed 25 percent of the bank's capital structure (tier 1 capital plus the allowance for loan and lease losses). A concentration exists when the extensions of credit or other obligations possess similar risk characteristics. Typically, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry have been included in homogeneous risk groupings when assessing asset concentrations. Furthermore, a concentration may include the aggregate of all types of credit to or investment in a particular homogeneous risk grouping.

Limitations imposed by the various state and federal legal lending limits were intended to prevent an individual or a relatively small group from borrowing an undue amount of the bank's resources and to safeguard the bank's depositors by spreading the loans among a relatively large number of persons engaged in different businesses. However, lending limits alone are not sufficient to prevent and control concentrations of credit. Policy guidance for risk diversification should be formulated in conformity with both legal and prudent investment restrictions. Before bank management can limit the bank's involvement or perform the necessary review, it must recognize the various types of concentrations and implement systems to retrieve the information necessary to monitor and report concentrations. The Federal Reserve expects management to identify, measure, monitor, and control concentrations.

### TYPES OF CREDIT CONCENTRATIONS

There are numerous possibilities for determining concentrations within a loan portfolio. In evaluating a potential concentration, it is important to determine the key factors germane to the credits. Concentrations that are commonly identified in a loan portfolio include the following:

- Loans to a group of borrowers, perhaps unrelated, predicated on the collateral support

afforded by a debt or equity issue of a corporation. Regardless of whether the issuing entity is a listed concern or a closely held enterprise, a concentration may exist in the underlying collateral.

- Loans that are dependent on a particular agricultural crop or livestock herd. Banking institutions located in farming, dairying, or livestock areas may grant substantially all their loans to individuals or concerns engaged in and dependent on the agricultural industry. Concentrations of this type are commonplace and may be necessary if these banks are to adequately serve the needs of their communities.
- The aggregate amount of interim construction loans that do not have firm, permanent take-out commitments. In the event that permanent financing is not obtainable, the bank will have to continue financing the projects. This longer term financing subjects the bank to additional liquidity and possibly interest-rate risks, as well as to risks associated with the real estate itself.
- Loans to groups of borrowers who handle a product from the same industry. Although the borrowers may appear to be independent from one another, their financial conditions may be affected similarly if a slowdown occurs in their economic sector.

Concentrations may also occur in banks located in towns that are economically dominated by one or only a few business enterprises. In these situations, banks may extend a substantial amount of credit to these companies and to a large percentage of the companies' employees. If economic or other events cause the enterprise's operations to slow down or stop, heavy unemployment may result—with other job opportunities in the area limited or nonexistent.

In identifying asset concentrations, commercial and residential real estate loans can be viewed separately when their performance is not subject to similar economic or financial risks. In the same vein, commercial real estate development loans need not be grouped with residential real estate development loans, especially when the residential developer has firm, reliable purchase contracts for the sale of the homes upon their completion. Even within the commercial development and construction sector, distinctions for concentration purposes may be made,

when appropriate, between those loans that have firm take-out commitments and those that do not. Groups or classes of real estate loans should, of course, be combined and viewed as concentrations when they do share significant common characteristics and are similarly affected by adverse economic, financial, or business developments.

## IDENTIFYING LOAN CONCENTRATIONS

The examiner should understand and evaluate the effectiveness of the internal policies, systems, and controls that an institution uses to monitor and manage the risk associated with asset concentrations. Every institution should maintain adequate records that may be used to identify asset concentrations. The degree of sophistication of the reporting records will vary by the size of institution. For example, larger institutions may have the automated capability to segregate loans by Standard Industrial Classification (SIC) codes, while smaller institutions may generate asset concentration listings manually.

Regardless of the identification system used by the institution, the accuracy of listed concentrations, as well as the appropriateness of concentrations, should be verified during the examination. All new and any existing asset concentrations should be reported monthly to the institution's board of directors or other appropriate committee for review.

## RISK MANAGEMENT OF ASSET CONCENTRATIONS

Institutions with asset concentrations are expected to have in place effective policies, systems, and internal controls to monitor and manage this risk. The bank's board of directors is responsible for establishing appropriate risk parameters and for monitoring exposure, as well as for evaluating the methods used by management to manage and control concentration risk. Furthermore, the Board's Regulation F addresses exposure that may arise from a bank's relationship with its correspondents. Concentrations that involve excessive or undue risks require close scrutiny by the bank and should be reduced over a reasonable period of time. Banking organizations with a need to reduce asset concentrations are normally expected to develop a plan that is

realistic, prudent, and achievable in view of their particular circumstances and market conditions.

The purpose of an institution's policies should be to improve the overall quality of its portfolio. Institutions that have effective internal controls to manage and reduce excessive concentrations over a reasonable period of time need not automatically refuse credit to sound borrowers because of their particular industry or geographic location. Furthermore, a bank may be able to reduce the risks associated with concentrations through the strengthening of individual credits. For example, the bank may be able to obtain additional collateral or guarantees. In the event of deterioration, the bank's position would be improved because the additional collateral or guarantees provide a cushion against losses.

When concentration levels have been built up over an extended period, it may take time, in some cases several years, to achieve a more balanced and diversified portfolio mix. Given the institution's trade area, lack of economic diversity, or geographic location, reducing the existing concentration in the near term may be impossible. If a concentration does exist, the banking organization should have adequate systems and controls for reducing undue or excessive concentrations in accordance with a prudent plan. Strong credit policies and loan administration standards should provide adequate control for the risks associated with new loans. The institution should also maintain adequate capital to protect the institution while its portfolio is being restructured. For identified asset concentrations, bank management should be aware of not only the particular company's or industry's recent trends, but also of its future prospects.

## Alternatives for Reducing Concentrations

Some alternatives for institutions whose asset concentrations are not likely to be reduced in the near term are described below.

### *Increased Holdings of Capital*

To compensate for the additional risk that may be associated with an asset concentration, a bank may elect to maintain a higher capital ratio than would be required under the risk-based capital guidelines. This additional capital would provide support in the event the concentration

adversely affects the organization's financial position.

### *Increased Allowance for Loan and Lease Losses*

The banking organization may choose to factor a cushion for loan concentrations into its determination of an adequate allowance for loan and lease losses a basis-point cushion for loan concentrations in determining the minimum level. This cushion would be available to absorb some deterioration in loan concentrations.

### *Loan Participations*

If a banking institution has a concentration, it

may be possible to sell a portion of the loan portfolio in the secondary market to reduce its dependency on an asset group. If the institution is not large enough to participate in the secondary market, an alternative might be to sell loans, without recourse, to a correspondent bank that is also attempting to diversify its loan portfolio.

### *Government Guarantee Programs*

Another possible solution to reduce the risk associated with a loan concentration is to seek government guarantees of originated loans. In some cases, a government agency may be willing to guarantee (or insure) a portion of agricultural or small-business loans, thereby reducing the risk to the originating bank.

# Concentrations of Credit

## Examination Objectives

Effective date May 1996

## Section 2050.2

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1. To determine if the policies, practices, procedures, and internal controls regarding concentrations of credit are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the existence of any concentrations of credit.
4. To determine if any concentrations of credit represent a hazard to the soundness of the bank.
5. To determine that concentrations of credit do not violate applicable banking statutes.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient.

# Concentrations of Credit Examination Procedures

Effective date March 1984

## Section 2050.3

Examiners should obtain or prepare the information necessary to perform the appropriate procedural steps.

1. If selected for implementation, complete or update the Concentrations of Credits section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures.
4. Request the bank's schedules of concentrations that are reported to the board of directors and/or senior management at regular intervals and—
  - a. if schedules are not current, update and/or have bank personnel update them as of the examination date and
  - b. request that other examiners review the schedules for reasonableness relative to information developed in performing the examination procedures for the various departments.
5. If schedules of concentrations are not maintained or if the listing is incomplete, prepare or obtain the following schedules of obligations that exceed 25 percent of the bank's capital structure—
  - a. loans collateralized by a common security
  - b. loans, contingent liabilities, and/or other obligations to one borrower or a related group of borrowers
  - c. loans dependent upon a particular crop or herd
  - d. aggregate loans to major employers in the service area, their employees, and their major suppliers
  - e. loans within industry groups
  - f. out-of-normal territory loans
  - g. all construction or development loans without firm takeout commitments.
6. If the schedules were prepared by others, review them for reasonableness relative to information developed in performing the examination procedures for the various loan areas.
7. Obtain a listing of due from bank accounts.
8. Obtain from the examiner assigned "Investment Securities" the schedule of investments and money market instruments that exceed 10 percent of the bank's capital structure.
9. Combine the schedules obtained in steps 4 through 8 and determine concentrations that equal or exceed 25 percent of the bank's capital structure. The remaining procedures apply only to these concentrations.
10. From the schedule of loans collateralized by a common security, eliminate all borrowers for whom the common security can be considered excess collateral, then review—
  - a. the trend in market prices and
  - b. current financial information, if appropriate.
11. For loans dependent upon a particular crop or herd—
  - a. review the bank's files for information on market conditions, future markets, and estimated prices and
  - b. determine any adverse trends that might affect payment of the concentrations.
12. For loans dependent upon major employers—
  - a. review financial and other available information on the company and evaluate its ability to continue as an ongoing entity,
  - b. review excerpts from trade papers or periodicals in bank files to determine that bank management is adequately informed on the business activity of the company, and
  - c. note any adverse trends that might affect the collectibility of the loans in the concentrations.
13. For loans within industry groups—
  - a. review financial and other available information on each industry and evaluate its ability to continue as a viable industry,
  - b. review the bank's files to determine that management is adequately informed on the activities of the industry, and
  - c. determine any adverse trends that might affect the collectibility of the loans included in the concentrations.
14. For due from bank accounts, inquire as to the reasonableness of the account relative to the activity and services provided.
15. Discuss with management—

- a. the adequacy of written policies regarding concentrations of credit,
  - b. the manner in which the bank's officers are operating in conformance with established policies,
  - c. concentrations that will appear in the report of examination, and
  - d. any matter requiring immediate attention.
16. Prepare, in appropriate form, all information regarding concentrations for inclusion in the report of examination. A comment should be made regarding each concentration, particularly regarding the percentage of the bank's capital accounts (total capital) that the total of each concentration represents. Examiners should avoid direct requests for reduction in the concentration unless facts are included that would support this action.
17. Update the workpapers with any information that will facilitate future examinations.

# Concentrations of Credit Internal Control Questionnaire

Effective date March 1984

Section 2050.4

Review the bank's internal controls, policies, practices, and procedures relating to concentrations of credit. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

## POLICIES

1. Has a policy been adopted that specifically addresses concentrations of credits?
2. Does the policy include deposits and other financial transactions with financial institutions?
3. Have controls been instituted to monitor the following types of concentrations:
  - a. loans and other obligations of one borrower
  - b. loans predicated on the collateral support afforded by a debt or equity issue of a corporation
  - c. loans to a company dominant in the local economy, its employees, and major suppliers
  - d. loans dependent upon one crop or herd
  - e. loans dependent upon one industry group
  - f. loans considered out of normal territory
4. Are periodic reports of concentrations required to be submitted to the board or its committee for review (if so, state frequency \_\_\_\_\_)?

5. Are the periodic reports checked for accuracy by someone other than the preparer before being submitted to the board or its committee?
6. When concentrations exist predicated upon a particular crop or herd of livestock, does the bank attempt to diversify the inherent potential risk by means of—
  - a. participations or
  - b. arrangements with governmental agencies such as—
    - guarantees or
    - lending arrangements?
7. When concentrations exist predicated upon a particular industry, does the bank make a periodic review of industry trends?

## CONCLUSION

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



The criteria used to assign quality ratings to extensions of credit that exhibit potential problems or well-defined weaknesses are primarily based upon the degree of risk and the likelihood of orderly repayment, and their effect on a bank's safety and soundness. Extensions of credit that exhibit potential weaknesses are categorized as "special mention," while those that exhibit well-defined weaknesses and a distinct possibility of loss are assigned to the more general category of "classified." The term "classified" is subdivided into more specific subcategories ranging from least to most severe: "substandard," "doubtful," and "loss." The amount of classified extensions of credit as a percent of capital represents the standard measure of expressing the overall quality of a bank's loan portfolio.

These classification guidelines are only applied to individual credits, even if entire portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each extension of credit should be based upon the fundamental characteristics affecting the collectibility of that particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits in the same industry that are not affected by the problems of the troubled sector(s).

### ASSESSMENT OF CREDIT QUALITY

The evaluation of each credit should be based upon the fundamentals of the particular credit, including, at a minimum—

- the overall financial condition and resources of the borrower, including the current and stabilized cash flow (capacity);
- the credit history of the borrower;
- the borrower's or principal's character;
- the purpose of the credit relative to the source of repayment; and
- the types of secondary sources of repayment available, such as guarantor support and the collateral's value and cash flow, when they are not a primary source of repayment. (Undue

reliance on secondary sources of repayment should be questioned, and the bank's policy about permitting such a practice should be reviewed.)

The longer the tenure of the borrower's extension of credit or contractual right to obtain funds, the greater the risk of some adverse development in the borrower's ability to repay the funds. This is because confidence in the borrower's repayment ability is based upon the borrower's past financial performance as well as projections of future performance. Failure of the borrower to meet its financial projections is a credit weakness, but does not necessarily mean the extension of credit should be considered as special mention or be classified. On the other hand, the inability to generate sufficient cash flow to service the debt is a well-defined weakness that jeopardizes the repayment of the debt and, in most cases, merits classification. When determining which credit-quality rating category is appropriate, the examiner should consider the extent of the shortfall in the operating figures, the support provided by any pledged collateral, and/or the support provided by cosigners, endorsers, or guarantors.

### Delinquent Extensions of Credit

One of the key indicators of a problem credit is a borrower's inability to meet the contractual repayment terms of an extension of credit. When this occurs, the extension of credit is identified as past due or delinquent. An extension of credit that is *not* delinquent may be identified as special mention or classified. Nondelinquent extensions of credit (also referred to as "performing" or "current") should be classified when well-defined weaknesses exist that jeopardize repayment. Examples of well-defined weaknesses include the lack of credible support for full repayment from reliable sources, or a significant departure from the intended source of repayment. This latter weakness warrants concern because a delinquent credit may have been brought current through loan or credit modifications, refinancing, or additional advances.

## SPECIAL MENTION CATEGORY

A special mention extension of credit is defined as having potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may, *at some future date*, result in the deterioration of the repayment prospects for the credit or the institution's credit position. Special mention credits are not considered as part of the classified extensions of credit category and do not expose an institution to sufficient risk to warrant classification.

Extensions of credit that might be detailed in this category include those in which—

- the lending officer may be unable to properly supervise the credit because of an inadequate loan or credit agreement;
- questions exist regarding the condition of and/or control over collateral;
- economic or market conditions may unfavorably affect the obligor in the future;
- a declining trend in the obligor's operations or an imbalanced position in the balance sheet exists, but not to the point that repayment is jeopardized; and
- other deviations from prudent lending practices are present.

The special mention category should not be used to identify an extension of credit that has as its sole weakness credit-data or documentation exceptions not material to the repayment of the credit. It should also not be used to list extensions of credit that contain risks usually associated with that particular type of lending. Any extension of credit involves certain risks, regardless of the collateral or the borrower's capacity and willingness to repay the debt.

For example, an extension of credit secured by accounts receivable has a certain degree of risk, but the risk must have increased beyond that which existed at origination to categorize the credit as special mention. Other characteristics of accounts receivable warranting identification as special mention include a rapid increase in receivables without bank knowledge of the causative factors, concentrations in receivables lacking proper credit support, or lack of on-site audits of the bank's borrower.

## CLASSIFICATION CATEGORIES

### Split Classifications

When classifying a particular credit, it may not be appropriate to list the entire balance under one credit-quality category. This situation is commonly referred to as a "split classification" and may be appropriate in certain instances, especially when there is more certainty regarding the collectibility of one portion of an extension of credit than another. Split classifications may also involve special mention as well as "pass" credits, those that are neither special mention nor classified. Extensions of credit that exhibit well-defined credit weaknesses may warrant classification based on the description of the following three classification categories.<sup>1</sup>

### Substandard Extensions of Credit

A "substandard" extension of credit is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Extensions of credit so classified must have a well-defined weakness or

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1. Guidelines for the uniform classification of consumer-installment extensions of credit and credit card plans, as well as classification guidelines for troubled commercial real estate credits, are discussed in detail in sections 2130.1 and 2090.1, respectively.

weaknesses that jeopardize the liquidation<sup>2</sup> of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard.

## Doubtful Extensions of Credit

An extension of credit classified “doubtful” has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to the advantage of and strengthen the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors may include a proposed merger or acquisition, liquidation proceedings, capital injection, perfecting liens on additional collateral, or refinancing plans.

Examiners should avoid classifying an entire credit as doubtful when collection of a specific portion appears highly probable. An example of proper use of the doubtful category is the case of a company being liquidated, with the trustee-in-bankruptcy indicating a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the bank. In this situation, estimates are based on liquidation-value appraisals with actual values yet to be realized. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent. A proper classification of such a credit would show 40 percent substandard, 25 percent doubtful, and 35 percent loss.

Examiners should generally avoid repeating a doubtful classification at subsequent examinations, as the time between examinations should be sufficient to resolve pending factors. This is not to say that situations do not occur when

continuation of the doubtful classification is warranted. However, the examiner should avoid undue continuation if repeatedly, over the course of time, pending events do not occur and repayment is again deferred awaiting new developments.

## Loss Extensions of Credit

Extensions of credit classified “loss” are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the credit has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified loss should be promptly charged off. (See SR-04-9 and its attachment.)

Banks should not be allowed to attempt long-term recoveries while the credit remains on the bank’s books. Losses should be taken in the period in which they surface as uncollectible.

In some cases, examiners should determine a reasonable carrying value for a distressed extension of credit and require a write-down through a charge to the allowance for loan and lease losses, or to other operating expenses in the case of an “other asset.” Such a determination should be based on tangible facts recorded in the bank’s credit file and contained in reports on problem credits submitted to the board of directors or its committee, and not solely on verbal assurances from a bank officer.

## SITUATIONS NOT REQUIRING CLASSIFICATION

It is generally not necessary to classify extensions of credit and contingent liabilities that are adequately protected by the current sound worth and debt-service capacity of the borrower, guarantor, or the underlying collateral. Further, a performing extension of credit should not automatically be identified as special mention, classified, or charged off solely because the value of the underlying collateral has declined to an amount that is less than the balance outstanding. Extensions of credit to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards should not be cat-

2. This terminology is used in the original classification definitions as set forth in the 1938 accord and its amendments. The term “liquidation” refers to the orderly repayment of the debt and not to a forced sale of the loan or its underlying collateral.

egorized as special mention unless a potential weakness exists, or classified unless a well-defined weakness exists that jeopardizes repayment. The existence of special mention or classified extensions of credit should not be identified as an imprudent banking practice, as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these extensions of credit.

### Partially Charged-Off Extensions of Credit

When an institution has charged off a portion of a credit and the remaining recorded balance of the credit (1) is being serviced (based upon reliable sources) and (2) is reasonably assured of collection, categorization of the remaining recorded balance as special mention or classified may not be appropriate.<sup>3</sup> For example, when the remaining recorded balance of an extension of credit is secured by readily marketable collateral, the portion that is secured by this collateral would generally not be identified as special mention or classified. This would be appropriate, however, if potential or well-defined weaknesses, respectively, continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally receive a credit rating no more severe than substandard.

A more severe credit rating than substandard for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, for example, when significant risk exposures are perceived, such as might be the case in bankruptcy or for credits collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

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3. The accrual/nonaccrual status of the credit must continue to be determined in accordance with the glossary section of the Instructions for the Consolidated Reports of Condition and Income (Call Report). Thus, while these partially charged-off credits may qualify for nonaccrual treatment, cash-basis recognition of income will be appropriate when the criteria specified in the Call Report guidance are met.

### Formally Restructured Extensions of Credit

Restructured troubled debt should be identified in the institution's internal credit-review system and closely monitored by management. When analyzing a formally restructured extension of credit, the examiner should focus on the ability of the borrower to repay the credit in accordance with its *modified terms*.<sup>4</sup> With formally restructured credits, it is frequently necessary to charge off a portion of the principal, due to the borrower's difficulties in meeting the contractual payments. In these circumstances, the same credit-risk assessment given to nonrestructured credits with partial charge-offs (see the previous subsection) would also generally be appropriate for a formally restructured credit. This includes *not* identifying the remaining recorded balance as special mention or classified if unwarranted. The assignment of special mention status to a formally restructured credit would be appropriate, if, after the restructuring, potential weaknesses remained. It would also be appropriate to classify a formally restructured extension of credit when well-defined weaknesses exist that jeopardize the orderly repayment of the credit, based upon its reasonable modified terms. For a further discussion of troubled debt restructurings, see the glossary section of the Instructions for the Consolidated Reports of Condition and Income and "Loan Portfolio Management," section 2040.1.

### ROLE OF GUARANTEES

The primary focus of a review of an extension of credit's quality is the original source of repayment and the borrower's ability and intent to fulfill the obligation without reliance on guarantors.<sup>5</sup> In situations involving troubled credits, however, the assessment of credit quality should also be based upon the support provided by guarantees. As a result, the lending institution

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4. An example of a restructured commercial real estate credit that does *not* have reasonable modified terms would be a mortgage that requires interest payments *only*, but no principal payments, despite the fact that the underlying collateral generates sufficient cash flow to pay both.

5. Some credits are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the credit based upon the guarantor's ability to repay the credit.

must have sufficient information concerning the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation.

## Examiner Treatment of Guarantees

A guarantee should provide support for repayment of indebtedness, in whole or in part, and be legally enforceable. It is predicated upon both the guarantor's financial capacity and willingness to provide support for a credit.

To assess the financial capacity of a guarantor and determine whether the guarantor can honor its contingent liabilities in the event required, examiners normally rely on their own analysis of a guarantor's financial strength. This includes an evaluation of the financial statements and the number and amount of guarantees currently committed to.

A guarantor's willingness to perform is assumed, unless there is evidence to the contrary. Since a guarantee is obtained with the intent of improving the repayment prospects of a credit, a guarantor may add sufficient strength to preclude or reduce the severity of the risk assessment.

Examiners should consider and analyze the following guarantee-related factors during the course of their review of extensions of credit:

- The degree to which the guarantors have demonstrated their ability and willingness to fulfill previous guarantees.
- Whether previously required performance under guarantees was voluntary or was the result of legal or other actions by the lender. Examiners should give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee under review.
- The economic incentives for performance by guarantors. This includes—
  - guarantors who have already partially performed under the guarantee;
  - guarantors who have other significant investments in the project;
  - guarantors whose other sound projects are

cross-collateralized or otherwise intertwined with the credit; or

- guarantees collateralized by readily marketable assets that are under the control of a third party.
- The extent to which guarantees are legally enforceable, although in general this is the only type of guarantee that should be relied upon.
  - Collection of funds under a guarantee should not be subject to significant delays or undue complexities or uncertainties that might render legal enforceability questionable.
  - Although the bank may have a legally enforceable guarantee, it may decide not to enforce it. The examiner's judgment should be favorably affected by previous extensions of credit evidencing the timely enforcement and successful collection of guarantees.
- The type of the guarantee. Some guarantees for real estate projects are limited in that they only pertain to the development and construction phases of a project. As such, these limited guarantees cannot be relied upon to support a troubled credit after the completion of these phases.

## OFF-BALANCE-SHEET ITEMS

The principal off-balance-sheet credit-related transactions likely to be encountered during loan reviews are loan commitments, commercial letters of credit, and standby letters of credit. When evaluating off-balance-sheet credit transactions for the purpose of assigning a credit-quality rating, the examiner should carefully consider whether the bank is irrevocably committed to advance additional funds under the credit agreement. If the bank must continue to fund the commitment and a potential weakness exists that, if left uncorrected, may at some future date result in the deterioration of repayment prospects or the bank's credit position, the amount of the commitment may be categorized as special mention. If there is a well-defined weakness that jeopardizes repayment of a commitment, classification may be warranted. If an amount is classified, it should be separated into two components: the direct amount (the amount that has already been advanced) and the indirect amount

(the amount that must be advanced in the future).

## Loan Commitments

Loan commitments are defined as legally binding obligations to extend credit (other than in the form of retail credit cards, check credit, and related plans) for which a fee or other compensation is typically received. Different types of loan commitments vary based upon the nature of the credit granted. Loan-commitment credit risk stems from the possibility that the creditworthiness of the customer will deteriorate between the time the commitment is made and the funds are advanced. (See “Contingent Claims from Off-Balance-Sheet Activities,” section 4110.1.)

## Commercial Letters of Credit

Commercial letters of credit involve a buyer of goods and a seller of goods and are instruments issued by a bank serving as an intermediary between the two for the resultant payment for the goods. Commercial letters of credit are customarily used to facilitate international trade due to the distances involved, as well as differences in legal, political, and business practices. Additionally, there may be a lack of familiarity between the buyer and seller. As a result, the bank substitutes its credit in place of the buyer's credit and promises on behalf of its customer to pay predetermined amounts of money to the seller against the delivery of documents indicating shipment of goods and representing title to those goods. If the shipping documents are in order, the bank is obligated to pay the seller through the issuance of a sight or time draft. The bank is then reimbursed by its customer for the amount of the shipment plus a fee for conducting the transaction.

Given the nature of the bank's commitment to pay for the goods on behalf of its customer, a commercial letter of credit is typically irrevocable. This means that it cannot be cancelled or revoked without the consent of all parties concerned. As a result, there is added credit risk for the issuing bank since it cannot cancel its commitment in the event the credit standing of its customer deteriorates, even if the deterioration occurs before the shipment of the goods.

## Standby Letters of Credit

Most standby letters of credit (SLCs) are unsecured and involve substituting the bank's credit standing for that of the bank's customer on behalf of a beneficiary. This occurs when the beneficiary needs to ensure that the bank's customer is able to honor its commitment to deliver the goods or services by the agreed-upon time and with the agreed-upon quality. For credit-analysis purposes, SLCs are to be treated like loans and represent just one type of extension of credit relative to the overall exposure extended by the bank to the borrower. SLCs can be divided into two main groups: “financial SLCs” and “nonfinancial SLCs.” Financial SLCs essentially guarantee repayment of financial instruments and are commonly used to “guarantee” payment on behalf of customers, issuers of commercial paper, or municipalities (relative to tax-exempt securities). Nonfinancial SLCs are essentially used as bid and performance bonds to “guarantee” completion of projects, such as building or road construction, or to guarantee penalty payment in case a supplier is unable to deliver goods or services under a contract.

## REQUIRED LOAN WRITE-UPS

A full loan write-up (see criteria below) is required for all significant or material classified or specially mentioned assets if (1) management disagrees with the disposition accorded by the examiner, or (2) the institution will be rated composite 3, 4, or 5. The write-ups will be used to support the classifications to management and, in the case of problem banks, to support any necessary follow-up supervisory actions.

An abbreviated write-up may be appropriate for other loans to illustrate a credit-administration weakness or to formalize certain decisions, document agreements, and clarify action plans for management. For example, bank management may have agreed to either collect or charge off a loan classified doubtful by the next call report date or to reverse interest accruals and place the loan on nonaccrual status. These agreements may be expressed in the report through a brief comment under the classification write-up.

The examiner may find it beneficial to list extensions of credit alphabetically by depart-



ment and/or branch. When more than one borrower is relevant to a single write-up, the alphabetization of the prime borrower or the parent corporation should determine the credit's position in the list. All other parties to the credit, including cosigners, endorsers, and guarantors, should be indicated directly under the maker of the notes or embodied within the write-up.

Although classifications and items listed for special mention may be listed alphabetically on the report page, examiners may elect to format the listing or write-ups in other ways to illustrate examination findings or conclusions. For example, examiners may wish to group classifications into categories of weakness and to use these listings to support loan-administration comments without providing a write-up for each classified item.

Notwithstanding this guidance, examiners have the flexibility of writing up more than the criticized assets, including any special mention credits, if deemed necessary. The decision to increase the number of write-ups should be based on factors such as the overall financial condition of the bank, quality of the loan portfolio, or adequacy of loan portfolio administration.

It is important that a sufficient number of write-ups with appropriate content be provided to support the examiner's assessment of the bank's problem loans, leases, and other extensions of credit. The write-ups should also support any comments pertaining to credit-administration policies and practices as they relate to this component of the bank's loan portfolio.

## General Guidelines for Write-Ups of Special Mention and Classified Extensions of Credit

Extension of credit write-ups may be in a narrative or bullet format, similar to the write-ups of shared national credits, where appropriate. When the special mention or classified credit consists of numerous extensions of credit to one borrower, or when multiple borrowers are discussed in one write-up, the write-up should be structured to clearly identify the credit facilities being discussed. For example, each extension of credit could be numbered when multiple credits are involved.

Before a write-up is prepared, the examiner should recheck central information files or other sources in the bank to determine that all of the obligor's debt, including related debt,<sup>6</sup> has been noted and included. The examiner should consider identifying accrued interest receivable as special mention or classified, especially when the cumulative effect on classified percentages is significant or the accrued interest is appropriately classified loss.

Even though the length of a write-up may be limited, the information and observations contained in the write-up must substantiate the credit's treatment as a special mention or classified credit. To prepare a write-up that brings out pertinent and fundamental facts, an examiner needs to have a thorough understanding of all the factors relative to the extension of credit. An ineffective presentation of the facts weakens a write-up and frequently casts doubt on the accuracy of the risk assessment. The examiner might consider emphasizing deviations from prudent banking practices as well as loan policy and procedure deficiencies that are pertinent to the credit's problems. When portions of a borrower's indebtedness are assigned to different risk categories, including portions identified as "pass," the examiner's comments should clearly set forth the reason for the split-rating treatment. A full write-up on items adversely classified or listed as special mention must provide sufficient detail to support the examiner's judgment concerning the rating assigned. To ensure that the write-ups provide a clear, concise, and logical discussion of material credit weaknesses, the following minimum categories of information should be presented, preferably in the order listed (see SR-99-24):

1. *A general description of the obligation.*
  - *Amount of exposure (both outstanding and contingent or undrawn) as follows:*
    - Summarize total related and contingent borrowings, including amounts previously charged off and recovered.
    - List the borrower's total related liabilities outstanding. Amounts making up this total refer to credits in which the borrower may have a related interest and is directly or indirectly obligated to repay, such as partnerships and joint ventures. The rule for determining what

6. The term "related" refers to direct and indirect obligations.

is included in related debt (aggregating debt), which ultimately has to do with ascertaining compliance with legal lending limits, is governed by state law.

- List and identify the obligor's contingent liabilities to the bank under examination. Contingent liabilities include items such as unadvanced portions of a line of credit or extension of credit (commitments), guarantees or endorsements, and commercial and standby letters of credit. Although contingent liabilities to other lenders represent an important component of the financial analysis of the obligor, they should not be listed in the write-up unless they are particularly relevant to the situation, or are portions of both related and contingent liabilities that represent participations purchased from and sold to other lenders. The latter example should be listed even though the entire relationship may not have been identified as special mention or classified. Additionally, only the classified portion of extensions of credit or contingent liabilities of the bank under examination should be listed in the appropriate column(s) of the classified asset page.
  - *The obligor and the obligor's location and type of business or occupation.* For the type of business or occupation of the obligor, indicate whether the business is a proprietorship, partnership, joint venture, or corporation. This information can be used to compare the purpose of the credit with the source(s) of repayment, and to compare the credit's structure with the obligor's repayment ability. The general identification of occupation, such as professional or wage earner, may not be definitive enough, so it may be necessary to indicate that, for example, the extension of credit is to a medical doctor.
- Types of businesses may be clearly indicated in the borrower's business name and may not require additional comment. For example, Apex Supermarket and Ajax Sporting Goods Store imply a retail supermarket and a retail sporting goods store. However, examiners should not be misled in their analysis of the credit; likewise, the write-up reviewer should not be misled by

assuming that a borrower is necessarily in the same line of business indicated by the borrower's business name. In the preceding example, if the borrower is primarily a wholesale grocery or sporting goods supplier, or if it radically deviates from the type of business indicated in its business name, the situation should be clarified. It is important to state the borrower's position in the marketing process—manufacturer, wholesaler, or retailer—and to indicate the types of goods or services.

- *Description and value of collateral.* The type of lien, collateral description and its condition and marketability, as well as the collateral's current value, date of valuation, and basis for the valuation, should be included. If values are estimated, the write-up should indicate the source of the valuation, such as the obligor's recent financial statement, an independent appraisal, or an internal management report. If valuations are not available, a statement to that effect should be included. A bank's failure to obtain collateral valuations, when available, is cause for criticism. Also include any other pertinent information that might impede or facilitate the possible sale of the collateral to repay the extension of credit.

When problem borrowers are involved, the sale of the collateral often becomes the sole or primary source of repayment. As a result, the valuation of the collateral becomes especially important when describing the credit, as described in the specific examples below.

If real estate is pledged to secure the credit, the write-up should provide a description of the property, the lien status, the amount of any prior lien, and the appraised value. If multiple parcels are securing the credit, appraised values should be listed for each parcel, including the date of the appraisal and the basis for the value. When bank staff or examiners' challenges to appraisal assumptions are supported, the resulting adjustment in value for credit-analysis purposes should be indicated. If the property held as collateral has tenants, its cash flow should be noted and the financial strength of the major lessees commented upon, if appropriate.

If the collateral represents shares of or an interest in a closely held company, the



shares or ownership interest held should be indicated in relation to the total shares outstanding, and the financial condition of the closely held company should be summarized in the write-up. Additionally, the approximate value of the closely held company, as indicated by its financial statements, should be compared for consistency with the value of the company as indicated on the principal's or partner's personal financial statement. The values often do not correlate to the extent they should, which typically indicates overvaluation of the asset on the balance sheet of the entity owning the shares or ownership interest.

If a blanket lien on assets, such as receivables, inventory, or equipment, is pledged as collateral, the current estimated value of each asset type should be shown separately. The basis for these values can come from various sources, which should be indicated:

- If receivables are pledged as collateral for an asset-based extension of credit, a current aging report and an assessment of the appropriateness of the advance ratio is usually necessary to determine their collectibility and value.
  - If inventory is pledged as collateral for an asset-based extension of credit, an assessment of the appropriateness of the advance ratio is necessary. Additionally, the value varies with the condition and marketability of the inventory.
  - If listed securities or commodities are pledged as collateral, the market value and date of valuation should be noted.
  - *Notation if borrower is an insider or a related interest of an insider.*
  - *Guarantors and a brief description of their ability to act as a source of repayment.* If the financial strength of guarantors has changed significantly since the initial guarantee of the credit facility, this should be noted. The relationship of the guarantors to the borrower should be identified, including a brief description of the guarantors' ability (financial strength) to serve as a source of repayment independent of the borrower. Any collateral supporting the guarantees should also be stated. See the previous subsection, "Role of Guarantees," and SR-91-24 for further guidance on considering guarantees for credit-analysis purposes.
  - *Amounts previously classified.*
  - *Repayment terms and historical performance, including prior charge-offs, and current delinquency status (with notation if the credit is currently on nonaccrual status).* Any changes to the original repayment terms, whether initiated by bank management or the obligor, should be detailed with an appropriate analysis of the changes included in the write-up. Renewals, extensions, and rewritten notes that deviate from the stated purpose and repayment expectations, as approved by management, should be discussed in light of their effect on the quality of the credit. Restructurings should be discussed in terms of their reasonable objectives, focusing on the prospects for full repayment in accordance with the modified terms.
    - It may be prudent to state the purpose of the credit. The purpose can be compared with the intended source of repayment for appropriateness. For example, a working capital extension of credit generally should not depend on the sale of real estate for repayment. Additionally, the obligor's prior business experience should correlate to the credit's purpose.
2. *A summary listing of weaknesses resulting in classification or special mention treatment.*
  3. *A reference to any identified deficiencies in the item that will support loan-administration or violation comments elsewhere in the report.* This information may consist of deficiencies in credit and collateral documentation or violations of law that have a material impact on credit quality. Loan-portfolio-administration performance includes, but is not limited to—
    - changes in asset quality since the last examination;
    - the appropriateness of loan-underwriting standards;
    - the adequacy of—
      - loan documentation;
      - management information systems;
      - internal control systems; and
      - loan-loss reserves;
    - the accuracy of internal loan-rating systems;
    - the ability and experience of lending officers, as well as other personnel managing the lending function; and
    - changes in lending policies or procedures since the last examination.

4. *If management disagrees with the classification, a statement to that effect along with management's rationale.* Information could include selected data from the most recent fiscal and interim financial statements (discussion of items such as leverage, liquidity, and cash flow) when the primary reason for the write-up relates to the borrower's financial condition or operating performance. Cost of goods sold, nonrecurring expenses, dividends, or other items indicating deterioration in the credit quality may also be highlighted. Any stated value of the borrower's encumbered assets should be set off against specific debt to arrive at the unprotected balance, if applicable. In addition, the examiner should identify encumbered assets that are pledged elsewhere.
5. *A concise description of any management action taken or planned to address the weakness in the asset.* The action plan should focus on a concise description of management's workout or action plan to improve the credit's collectibility or to liquidate the debt. Review of the bank's documented workout plan should give an examiner a clear idea of past efforts to improve the prospect of collectibility and management's current efforts and future strategy. The plan should clearly state the bank's goals and corresponding timetable as they appear at that point, including items such as the degree of repayment envisioned and the proceeds anticipated from the sale of the collateral. Based on this information, the examiner should succinctly summarize in the write-up the bank's collection efforts to date and its ongoing plans to address the situation.

## Optional Information for Write-ups

At the examiner's discretion, other information may be included in loan write-ups. For example the examiner may want to include current financial information on the borrower, cosigners, and guarantors. The additional information may consist of discussions regarding current balance sheets and operating statements. If discussed, the examiner should indicate whether the financial statements have been audited, reviewed, compiled, or prepared by the borrower, and whether they are fiscal or interim statements. If the statements are audited, the examiner should indicate the type of opinion expressed—unqualified, qualified, disclaimer, or adverse—and whether the auditor is a certified public accountant. If the opinion is qualified, note the reason(s) given by the auditor.

When the examiner includes comments regarding the borrower's financial condition, the comments should always highlight credit weaknesses in a manner that supports the risk assessment. It is important that sufficient detail is provided to identify unfavorable factors. A trend analysis or details of balance-sheet, income-statement, or cash-flow items can be included. The examiner may also include comments when special mention or classified credits may exhibit favorable as well as unfavorable financial characteristics. Both types of pertinent factors may be included in the write-up as long as they are placed in the proper perspective to demonstrate the credit's inherent weaknesses.

The allowance for loan and lease losses (ALLL) is presented on the balance sheet as a contra-asset account that reduces the amount of the loan portfolio reported on the balance sheet. The purpose of the ALLL is to reflect *estimated credit losses* within a bank's portfolio of loans and leases. Estimated credit losses are estimates of the current amount of loans that are probable that the bank will be unable to collect given the facts and circumstances since the evaluation date (generally the balance sheet date). That is, estimated credit losses represent net charge-offs that are likely to be realized for a loan or group of loans as of the evaluation date.

All federally insured depository institutions must maintain an ALLL, except for federally insured branches and agencies of foreign banks. A bank determines the appropriate balance or level of the ALLL at least each quarter, periodically validating its methodology for estimating the ALLL (see SR-11-7), and by evaluating the collectibility of its loan and lease portfolio, including any accrued and unpaid interest. Increases or decreases to the ALLL are to be made through charges (debits) or credits to the "provision for loan and lease losses" (provision), an expense account on the bank's Consolidated Report of Income or income statement, and not through transfers from retained earnings or any segregation of retained earnings or other components of equity capital.

When there is information available to confirm that specific loans, or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL. Under no circumstances can loan or lease losses be charged directly to "retained earnings" and capital. Any subsequent recoveries on loans or leases previously charged off must be credited to the ALLL, provided, however, that the total amount credited to the allowance as recoveries of an individual loan (which may include amounts representing principal, interest, and fees) is limited to the amount previously charged off against the ALLL on that loan. Any amounts collected in excess of this limit should be recognized as income.

To illustrate these concepts, assume that Bank A has a loan and lease portfolio totaling \$100 million at the end of year 1 and an ALLL of \$1.25 million; thus, its net carrying amount for the loan portfolio on the balance sheet is \$98.75 million. Based on its most recent analy-

sis, Bank A has determined that an ALLL of \$1.5 million is necessary to cover its estimated credit losses as of the end of the fourth quarter. Therefore, in the fourth quarter of year 1, Bank A should record a provision for \$250,000, debiting this expense and crediting the ALLL for this amount to bring the ALLL to the appropriate level of \$1.5 million. Assume further that during the first quarter of year 2, Bank A identifies \$750,000 in uncollectible loans. It must charge off this amount against the ALLL by debiting the ALLL and crediting the individual loans for a total of \$750,000. Also assume that in the same first quarter of year 2, Bank A receives \$100,000 in cash recoveries on previously charged-off loans. These recoveries must be credited to the ALLL in that quarter. Thus, in the first quarter of year 2, Bank A's ALLL, which began the year at \$1.5 million, will have been reduced \$850,000 ( $\$1,500,000 - \$750,000 + \$100,000 = \$850,000$ ). However, management's ALLL analysis for the first quarter of year 2 indicates that an ALLL of \$1.2 million is appropriate. To bring the recorded ALLL to this level, Bank A must make a debit to the provision for loan and lease losses of \$350,000 ( $\$850,000 + \$350,000 = \$1.2$  million).

While the overall responsibility for maintaining the ALLL at an appropriate level rests with the bank's senior management and board of directors, the appropriateness of the ALLL and management's analysis of it are subject to examiner review. The examiner should make every effort to fully understand a bank's methods for determining the needed balance of its ALLL. During the process of conducting the examination, the examiner should take these methods into account when making a final determination on the appropriateness (adequacy) of the balance of the ALLL. The examiner may confer with bank management and any outside accountant or auditor that has advised management on its ALLL-review policies or practices.

If the examiner concludes that the reported ALLL level is not appropriate or determines that the ALLL evaluation process is based on the results of an unreliable loan review system or is otherwise deficient, recommendations for correcting these deficiencies, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination. The examiner's comments should cite any departures from generally accepted

accounting principles (GAAP) and any conventions of the following 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses as well as the 2001 policy statement (see section 2072.1). Additional supervisory action may also be taken based on the magnitude of the observed shortcomings in the ALLL process, including the materiality of any error in the reported amount of the ALLL.

## INTERAGENCY POLICY STATEMENT ON THE ALLOWANCE FOR LOAN AND LEASE LOSSES

This 2006 policy statement<sup>1</sup> revises and replaces the 1993 policy statement on the ALLL. It reiterates key concepts and requirements included in generally accepted accounting principles (GAAP) and existing ALLL supervisory guidance.<sup>2</sup> The principal sources of guidance on accounting for impairment in a loan portfolio under GAAP are Statement of Financial Accounting Standards No. 5, “Accounting for Contingencies” (FAS 5), and Statement of Financial Accounting Standards No. 114, “Accounting by Creditors for Impairment of a Loan” (FAS 114). In addition, the Financial Accounting Standards Board Viewpoints article that is included in Emerging Issues Task Force Topic D-80 (EITF D-80), “Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio,” presents questions and answers that provide specific guidance on the interaction between these two FASB statements and may be helpful in applying them.

In July 1999, the banking agencies and the Securities and Exchange Commission (SEC) issued a Joint Interagency Letter to Financial Institutions. The letter stated that the banking agencies and the SEC agreed on the following

1. This policy statement was adopted on December 13, 2006, by, and applies to, all depository institutions (institutions), except U.S. branches and agencies of foreign banks, that are supervised by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (the banking agencies). U.S. branches and agencies of foreign banks continue to be subject to any separate guidance that has been issued by their primary supervisory agency.

2. As discussed more fully below in the “Nature and Purpose of the ALLL” section, this policy statement and the ALLL generally do not address loans carried at fair value or loans held for sale. In addition, this policy statement provides only limited guidance on “purchased impaired loans.”

important aspects of loan loss allowance practices:

- Arriving at an appropriate allowance involves a high degree of management judgment and results in a range of estimated losses.
- Prudent, conservative—but not excessive—loan loss allowances that fall within an acceptable range of estimated losses are appropriate. In accordance with GAAP, an institution should record its best estimate within the range of credit losses, including when management’s best estimate is at the high end of the range.
- Determining the allowance for loan losses is inevitably imprecise, and an appropriate allowance falls within a range of estimated losses.
- An “unallocated” loan loss allowance is appropriate when it reflects an estimate of probable losses, determined in accordance with GAAP, and is properly supported.
- Allowance estimates should be based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio.
- The loan loss allowance should take into consideration all available information existing as of the financial statement date, including environmental factors such as industry, geographical, economic, and political factors.

In July 2001, the banking agencies issued the Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions (2001 Policy Statement). The policy statement is designed to assist institutions in establishing a sound process for determining an appropriate ALLL and documenting that process in accordance with GAAP.<sup>3</sup> (See section 2072.1.)

In March 2004, the agencies also issued the Update on Accounting for Loan and Lease Losses. This guidance provided reminders of longstanding supervisory guidance as well as a listing of the existing allowance guidance that institutions should continue to apply.

3. See section 2072.1 for the 2001 Policy Statement. The SEC staff issued parallel guidance in July 2001, which is found in Staff Accounting Bulletin No. 102, “Selected Loan Loss Allowance Methodology and Documentation Issues” (SAB 102), which has been codified as Topic 6.L. in the SEC’s Codification of Staff Accounting Bulletins. Both SAB 102 and the codification are available on the SEC’s web site.

## Nature and Purpose of the ALLL

The ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. Because of its significance, each institution has a responsibility for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses (PLLL). To fulfill this responsibility, each institution should ensure controls are in place to consistently determine the ALLL in accordance with GAAP, the institution's stated policies and procedures, management's best judgment, and relevant supervisory guidance. As of the end of each quarter, or more frequently if warranted, each institution must analyze the collectibility of its loans and leases held for investment<sup>4</sup> (hereafter referred to as "loans") and maintain an ALLL at a level that is appropriate and determined in accordance with GAAP. An appropriate ALLL covers estimated credit losses on individually evaluated loans that are determined to be impaired as well as estimated credit losses inherent in the remainder of the loan and lease portfolio. The ALLL does not apply, however, to loans carried at fair value, loans held for sale,<sup>5</sup> off-balance-sheet credit exposures<sup>6</sup> (for example, financial instruments such as off-balance-sheet loan commitments, standby letters of credit, and guarantees), or general or unspecified business risks.

For purposes of this policy statement, the term *estimated credit losses* means an estimate of the current amount of loans that it is probable the institution will be unable to collect given

facts and circumstances since the evaluation date. Thus, estimated credit losses represent net charge-offs that are likely to be realized for a loan or group of loans. These estimated credit losses should meet the criteria for accrual of a loss contingency (that is, through a provision to the ALLL) set forth in GAAP.<sup>7</sup> When available information confirms that specific loans, or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL. For "purchased impaired loans,"<sup>8</sup> GAAP prohibits "carrying over" or creating an ALLL in the initial recording of these loans. However, if, upon evaluation subsequent to acquisition, it is probable that the institution will be unable to collect all cash flows expected at acquisition on a purchased impaired loan (an estimate that considers both timing and amount), the loan should be considered impaired for purposes of applying the measurement and other provisions of FAS 5 or, if applicable, FAS 114.

Estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. For loans within the scope of FAS 114 that

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7. FAS 5 requires the accrual of a loss contingency when information available prior to the issuance of the financial statements indicates it is probable that an asset has been impaired at the date of the financial statements and the amount of loss can be reasonably estimated. These conditions may be considered in relation to individual loans or in relation to groups of similar types of loans. If the conditions are met, accrual should be made even though the particular loans that are uncollectible may not be identifiable. Under FAS 114, an individual loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. It is implicit in these conditions that it must be probable that one or more future events will occur confirming the fact of the loss. Thus, under GAAP, the purpose of the ALLL is not to absorb all of the risk in the loan portfolio, but to cover probable credit losses that have already been incurred.

8. A *purchased impaired loan* is defined as a loan that an institution has purchased, including a loan acquired in a purchase business combination, that has evidence of deterioration of credit quality since its origination and for which it is probable, at the purchase date, that the institution will be unable to collect all contractually required payments. When reviewing the appropriateness of the reported ALLL of an institution with purchased impaired loans, examiners should consider the credit losses factored into the initial investment in these loans when determining whether further deterioration—for example, decreases in cash flows expected to be collected—has occurred since the loans were purchased. The bank's consolidated reports of condition and income and the disclosures in the bank's financial statements may provide useful information for examiners in reviewing these loans. Refer to the AICPA's Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer," for further guidance on the appropriate accounting.

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4. Consistent with the American Institute of Certified Public Accountants' (AICPA) Statement of Position 01-6, "Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others," loans and leases held for investment are those loans and leases that the institution has the intent and ability to hold for the foreseeable future or until maturity or payoff.

5. See "Interagency Guidance on Certain Loans Held for Sale" (March 26, 2001) for the appropriate accounting and reporting treatment for certain loans that are sold directly from the loan portfolio or transferred to a held-for-sale account. Loans held for sale are reported at the lower of cost or fair value. Declines in value occurring after the transfer of a loan to the held-for-sale portfolio are accounted for as adjustments to a valuation allowance for held-for-sale loans and not as adjustments to the ALLL.

6. Credit losses on off-balance-sheet credit exposures should be estimated in accordance with FAS 5. Any allowance for credit losses on off-balance-sheet exposures should be reported on the balance sheet as an "other liability," and not as part of the ALLL.



are individually evaluated and determined to be impaired,<sup>9</sup> these estimates should reflect consideration of one of the standard's three impairment measurement methods as of the evaluation date: (1) the present value of expected future cash flows discounted at the loan's effective interest rate,<sup>10</sup> (2) the loan's observable market price, or (3) the fair value of the collateral if the loan is collateral dependent.

An institution may choose the appropriate FAS 114 measurement method on a loan-by-loan basis for an individually impaired loan, except for an impaired collateral-dependent loan. The agencies require impairment of a collateral-dependent loan to be measured using the fair value of collateral method. As defined in FAS 114, a loan is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral. In general, any portion of the recorded investment in a collateral-dependent loan (including any capitalized accrued interest, net deferred loan fees or costs, and unamortized premium or discount) in excess of the fair value of the collateral that can be identified as uncollectible, and is therefore deemed a confirmed loss, should be promptly charged off against the ALLL.<sup>11</sup>

All other loans, including individually evaluated loans determined not to be impaired under FAS 114, should be included in a group of loans that is evaluated for impairment under FAS 5.<sup>12</sup> While an institution may segment its loan portfolio into groups of loans based on a variety of factors, the loans within each group should have similar risk characteristics. For example, a loan that is fully collateralized with risk-free assets should not be grouped with uncollateralized

loans. When estimating credit losses on each group of loans with similar risk characteristics, an institution should consider its historical loss experience on the group, *adjusted for changes in trends, conditions, and other relevant factors* that affect repayment of the loans as of the evaluation date.

For analytical purposes, an institution should attribute portions of the ALLL to loans that it evaluates and determines to be impaired under FAS 114 and to groups of loans that it evaluates collectively under FAS 5. However, the ALLL is available to cover all charge-offs that arise from the loan portfolio.

## Responsibilities of the Board of Directors and Management

### *Appropriate ALLL Level*

Each institution's management is responsible for maintaining the ALLL at an appropriate level and for documenting its analysis according to the standards set forth in the 2001 policy statement. Thus, management should evaluate the ALLL reported on the balance sheet as of the end of each quarter or more frequently if warranted, and charge or credit the PLLL to bring the ALLL to an appropriate level as of each evaluation date. The determination of the amounts of the ALLL and the PLLL should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the evaluation date. Management's evaluation is subject to review by examiners. An institution's failure to analyze the collectibility of the loan portfolio and maintain and support an appropriate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound practice.

In carrying out its responsibility for maintaining an appropriate ALLL, management is expected to adopt and adhere to written policies and procedures that are appropriate to the size of the institution and the nature, scope, and risk of its lending activities. At a minimum, these policies and procedures should ensure that—

- the institution's process for determining an appropriate level for the ALLL is based on a comprehensive, well-documented, and consis-

9. FAS 114 does not specify how an institution should identify loans that are to be evaluated for collectibility nor does it specify how an institution should determine that a loan is impaired. An institution should apply its normal loan review procedures in making those judgments. Refer to the ALLL interpretations for further guidance.

10. The "effective interest rate" on a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs and any premium or discount existing at the origination or acquisition of the loan).

11. For further information, refer to the illustration in Appendix B of the 2001 Policy Statement (the appendix in section 2072.1).

12. An individually evaluated loan that is determined not to be impaired under FAS 114 should be evaluated under FAS 5 when specific characteristics of the loan indicate that it is probable there would be estimated credit losses in a group of loans with those characteristics. For further guidance, refer to the frequently asked questions (FAQs) that were distributed with this policy statement.

tently applied analysis of its loan portfolio.<sup>13</sup> The analysis should consider all significant factors that affect the collectibility of the portfolio and should support the credit losses estimated by this process.

- the institution has an effective loan review system and controls (including an effective loan classification or credit grading system) that identify, monitor, and address asset quality problems in an accurate and timely manner.<sup>14</sup> To be effective, the institution's loan review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio.
- the institution has adequate data capture and reporting systems to supply the information necessary to support and document its estimate of an appropriate ALLL.
- the institution evaluates any loss estimation models before they are employed and modifies the models' assumptions, as needed, to ensure that the resulting loss estimates are consistent with GAAP. To demonstrate this consistency, the institution should document its evaluations and conclusions regarding the appropriateness of estimating credit losses with the models or other estimation tools. The institution should also document and support any adjustments made to the models or to the output of the models in determining the estimated credit losses.
- the institution promptly charges off loans, or portions of loans, that available information confirms to be uncollectible.
- the institution periodically validates the ALLL methodology. This validation process should be done by a party who is independent of the institution's credit approval and ALLL estimation processes in conformance with SR-11-7, of the ALLL methodology and its application in order to confirm its effectiveness. A

13. As noted in the 2001 Policy Statement, an institution with less complex lending activities and products may find it more efficient to combine a number of procedures while continuing to ensure that the institution has a consistent and appropriate ALLL methodology. Thus, much of the supporting documentation required for an institution with more complex products or portfolios may be combined into fewer supporting documents in an institution with less complex products or portfolios.

14. Loan review and loan classification or credit grading systems are discussed in attachment 1 of this policy statement. In addition, state member banks should refer to the asset quality standards in the Interagency Guidelines Establishing Standards for Safety and Soundness, which were adopted by the Federal Reserve Board (see Appendix D-1, 12 CFR 208).

party who is independent of these processes could be the internal audit staff, a risk management unit of the institution, an external auditor (subject to applicable auditor independence standards), or another contracted third party from outside the institution. One party need not perform the entire analysis as the validation can be divided among various independent parties.

The board of directors is responsible for overseeing management's significant judgments and estimates pertaining to the determination of an appropriate ALLL. This oversight should include but is not limited to—

- reviewing and approving the institution's written ALLL policies and procedures at least annually;
- reviewing management's assessment and justification that the loan review system is sound and appropriate for the size and complexity of the institution;
- reviewing management's assessment and justification for the amounts estimated and reported each period for the PLLL and the ALLL; and
- requiring management to periodically validate and, when appropriate, revise the ALLL methodology.

For purposes of the Consolidated Reports of Condition and Income for a Bank (Call Report), an appropriate ALLL (after deducting all loans and portions of loans confirmed loss) should consist only of the following components (as applicable),<sup>15</sup> the amounts of which take into account *all relevant facts and circumstances as of the evaluation date*:

- For loans within the scope of ASC Topic 310, Receivables (formerly FAS 114, "Accounting by Creditors for Impairment of a Loan") that are individually evaluated and found to be impaired, the associated ALLL should be based upon one of the three impairment measurement methods specified in FAS 114.<sup>16</sup>
- For all other loans, including individually

15. A component of the ALLL that is labeled "unallocated" is appropriate when it reflects estimated credit losses determined in accordance with GAAP and is properly supported and documented.

16. As previously noted, the use of the fair value of collateral method is required for an individually evaluated loan that is impaired if the loan is collateral dependent.

evaluated loans determined not to be impaired under FAS 114,<sup>17</sup> the associated ALLL should be measured under ASC Subtopic 450-20, Contingencies—Loss Contingencies (formerly FAS 5, “Accounting for Contingencies”) and should provide for all estimated credit losses that have been incurred on groups of loans with similar risk characteristics.

- For estimated credit losses from transfer risk on cross-border loans, the impact to the ALLL should be evaluated individually for impaired loans under FAS 114 or evaluated on a group basis under FAS 5. See . . . this policy statement’s . . . attachment 2 for further guidance on considerations of transfer risk on cross-border loans.
- For estimated credit losses on accrued interest and fees on loans that have been reported as part of the respective loan balances on the institution’s balance sheet, the associated ALLL should be evaluated under FAS 114 or FAS 5 as appropriate, if not already included in one of the preceding components.

Because deposit accounts that are overdrawn (that is, overdrafts) must be reclassified as loans on the balance sheet, overdrawn accounts should be included in one of the first two components above, as appropriate, and evaluated for estimated credit losses.

Determining the appropriate level for the ALLL is inevitably imprecise and requires a high degree of management judgment. Management’s analysis should reflect a prudent, conservative, but not excessive ALLL that falls within an acceptable range of estimated credit losses. When a range of losses is determined, institutions should maintain appropriate documentation to support the identified range and the rationale used for determining the best estimate from within the range of loan losses.

As discussed more fully in attachment 1 of this policy statement, it is essential that institutions maintain effective loan review systems. An effective loan review system should work to ensure the accuracy of internal credit classification or grading systems and, thus, the quality of the information used to assess the appropriateness of the ALLL. The complexity and scope of an institution’s ALLL evaluation process, loan review system, and other relevant controls should be appropriate for the size of the institution and the nature of its lending activities. The evalua-

tion process should also provide for sufficient flexibility to respond to changes in the factors that affect the collectibility of the portfolio.

Credit losses that arise from the transfer risk associated with an institution’s cross-border lending activities require special consideration. In particular, for banks with cross-border lending exposure, management should determine that the ALLL is appropriate to cover estimated losses from transfer risk associated with this exposure over and above any minimum amount that the Interagency Country Exposure Review Committee requires to be provided in the Allocated Transfer Risk Reserve (or charged off against the ALLL). These estimated losses should meet the criteria for accrual of a loss contingency set forth in GAAP. (See attachment 2 for factors to consider.)

### *Factors to Consider in the Estimation of Credit Losses*

Estimated credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. Normally, an institution should determine the historical loss rate for each group of loans with similar risk characteristics in its portfolio based on its own loss experience for loans in that group. While historical loss experience provides a reasonable starting point for the institution’s analysis, historical losses—or even recent trends in losses—do not by themselves form a sufficient basis to determine the appropriate level for the ALLL. Management also should consider those qualitative or environmental factors that are likely to cause estimated credit losses associated with the institution’s existing portfolio to differ from historical loss experience, including but not limited to—

- changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices not considered elsewhere in estimating credit losses;
- changes in international, national, regional, and local economic and business conditions and developments that affect the collectibility of the portfolio, including the condition of various market segments;<sup>18</sup>

18. Credit loss and recovery experience may vary significantly depending upon the stage of the business cycle. For

17. See footnote 12.



- changes in the nature and volume of the portfolio and in the terms of loans;
- changes in the experience, ability, and depth of lending management and other relevant staff;
- changes in the volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans;<sup>19</sup>
- changes in the quality of the institution's loan review system;
- changes in the value of underlying collateral for collateral-dependent loans;
- the existence and effect of any concentrations of credit, and changes in the level of such concentrations; and
- the effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's existing portfolio.

In addition, changes in the level of the ALLL should be directionally consistent with changes in the factors, taken as a whole, that evidence credit losses, keeping in mind the characteristics of an institution's loan portfolio. For example, if declining credit quality trends relevant to the types of loans in an institution's portfolio are evident, the ALLL level as a percentage of the portfolio should generally increase, barring unusual charge-off activity. Similarly, if improving credit quality trends are evident, the ALLL level as a percentage of the portfolio should generally decrease.

### *Measurement of Estimated Credit Losses*

**FAS 5.** When measuring estimated credit losses on groups of loans with similar risk characteristics in accordance with FAS 5, a widely used method is based on each group's historical net charge-off rate adjusted for the effects of the qualitative or environmental factors discussed previously. As the first step in applying this method, management generally bases the historical net charge-off rates on the "annualized" historical gross loan charge-offs, less recoveries,

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example, an over reliance on credit loss experience during a period of economic growth will not result in realistic estimates of credit losses during a period of economic downturn.

19. For banks, adversely classified or graded loans are loans rated "Substandard" (or its equivalent) or worse under its loan classification system.

recorded by the institution on loans in each group.

Methodologies for determining the historical net charge-off rate on a group of loans with similar risk characteristics under FAS 5 can range from the simple average of, or a determination of the range of, an institution's annual net charge-off experience to more complex techniques, such as migration analysis and models that estimate credit losses.<sup>20</sup> Generally, institutions should use at least an "annualized" or twelve-month average net charge-off rate that will be applied to the groups of loans when estimating credit losses. However, this rate could vary. For example, loans with effective lives longer than twelve months often have workout periods over an extended period of time, which may indicate that the estimated credit losses should be greater than that calculated based solely on the annualized net charge-off rate for such loans. These groups may include certain commercial loans as well as groups of adversely classified loans. Other groups of loans may have effective lives shorter than twelve months, which may indicate that the estimated credit losses should be less than that calculated based on the annualized net charge-off rate.

Regardless of the method used, institutions should maintain supporting documentation for the techniques used to develop the historical loss rate for each group of loans. If a range of historical loss rates is developed instead for a group of loans, institutions should maintain documentation to support the identified range and the rationale for determining which rate is the best estimate within the range of loss rates. The rationale should be based on management's assessment of which rate is most reflective of

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20. Annual charge-off rates are calculated over a specified time period (for example, three years or five years), which can vary based on a number of factors including the relevance of past periods' experience to the current period or point in the credit cycle. Also, some institutions remove loans that become adversely classified or graded from a group of nonclassified or nongraded loans with similar risk characteristics in order to evaluate the removed loans individually under FAS 114 (if deemed impaired) or collectively in a group of adversely classified or graded loans with similar risk characteristics under FAS 5. In this situation, the net charge-off experience on the adversely classified or graded loans that have been removed from the group of nonclassified or nongraded loans should be included in the historical loss rates for that group of loans. Even though the net charge-off experience on adversely classified or graded loans is included in the estimation of the historical loss rates that will be applied to the group of nonclassified or nongraded loans, the adversely classified or graded loans themselves are no longer included in that group for purposes of estimating credit losses on the group.

the estimated credit losses in the current loan portfolio.

After determining the appropriate historical loss rate for each group of loans with similar risk characteristics, management should consider those current qualitative or environmental factors that are likely to cause estimated credit losses as of the evaluation date to differ from the group's historical loss experience. Institutions typically reflect the overall effect of these factors on a loan group as an adjustment that, as appropriate, increases or decreases the historical loss rate applied to the loan group. Alternatively, the effect of these factors may be reflected through separate standalone adjustments within the FAS 5 component of the ALLL.<sup>21</sup> Both methods are consistent with GAAP, provided the adjustments for qualitative or environmental factors are reasonably and consistently determined, are adequately documented, and represent estimated credit losses. For each group of loans, an institution should apply its adjusted historical loss rate, or its historical loss rate and separate standalone adjustments, to the recorded investment in the group when determining its estimated credit losses.

Management must exercise significant judgment when evaluating the effect of qualitative factors on the amount of the ALLL because data may not be reasonably available or directly applicable for management to determine the precise impact of a factor on the collectibility of the institution's loan portfolio as of the evaluation date. Accordingly, institutions should support adjustments to historical loss rates and explain how the adjustments reflect current information, events, circumstances, and conditions in the loss measurements. Management should maintain reasonable documentation to support which factors affected the analysis and the impact of those factors on the loss measurement. Support and documentation includes descriptions of each factor, management's analysis of how each factor has changed over time, which loan groups' loss rates have been adjusted, the amount by which loss estimates have been adjusted for changes in conditions, an explanation of how management estimated the impact,

21. An overall adjustment to a portion of the ALLL that is not attributed to specific segments of the loan portfolio is often labeled "unallocated." Regardless of what a component of the ALLL is labeled, it is appropriate when it reflects estimated credit losses determined in accordance with GAAP and is properly supported.

and other available data that supports the reasonableness of the adjustments. Examples of underlying supporting evidence could include, but are not limited to, relevant articles from newspapers and other publications that describe economic events affecting a particular geographic area, economic reports and data, and notes from discussions with borrowers.

There may be times when an institution does not have its own historical loss experience upon which to base its estimate of the credit losses in a group of loans with similar risk characteristics. This may occur when an institution offers a new loan product or when it is a newly established (that is, *de novo*) institution. If an institution has no experience of its own for a loan group, reference to the experience of other enterprises in the same lending business may be appropriate, provided the institution demonstrates that the attributes of the group of loans in its portfolio are similar to those of the loan group in the portfolio providing the loss experience. An institution should only use another enterprise's experience on a short-term basis until it has developed its own loss experience for a particular group of loans.

*FAS 114.* When determining the FAS 114 component of the ALLL for an individually impaired loan,<sup>22</sup> an institution should consider estimated costs to sell the loan's collateral, if any, on a discounted basis, in the measurement of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the institution bases its measure of loan impairment on the present value of expected future cash flows discounted at the loan's effective interest rate, the estimates of these cash flows should be the institution's best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing the estimate of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. The likeli-

22. As noted in FAS 114, some individually impaired loans have risk characteristics that are unique to an individual borrower and the institution will apply the measurement methods on a loan-by-loan basis. However, some impaired loans may have risk characteristics in common with other impaired loans. An institution may aggregate those loans and may use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate as a means of measuring impairment of those loans.

hood of the possible outcomes should be considered in determining the best estimate of expected future cash flows.

### *Analyzing the Overall Measurement of the ALLL*

Institutions also are encouraged to use ratio analysis as a supplemental tool for evaluating the overall reasonableness of the ALLL. Ratio analysis can be useful in identifying divergent trends (compared with an institution's peer group and its own historical experience) in the relationship of the ALLL to adversely classified or graded loans, past due and nonaccrual loans, total loans, and historical gross and net charge-offs. Based on such analysis, an institution may identify additional issues or factors that previously had not been considered in the ALLL estimation process, which may warrant adjustments to estimated credit losses. Such adjustments should be appropriately supported and documented.

While ratio analysis, when used prudently, can be helpful as a supplemental check on the reasonableness of management's assumptions and analyses, it is not a sufficient basis for determining the appropriate amount for the ALLL. In particular, because an appropriate ALLL is an institution-specific amount, such comparisons do not obviate the need for a comprehensive analysis of the loan portfolio and the factors affecting its collectibility. Furthermore, it is inappropriate for the board of directors or management to make adjustments to the ALLL when it has been properly computed and supported under the institution's methodology for the sole purpose of reporting an ALLL that corresponds to the peer group median, a target ratio, or a budgeted amount. Institutions that have high levels of risk in the loan portfolio or are uncertain about the effect of possible future events on the collectibility of the portfolio should address these concerns by maintaining higher equity capital and not by arbitrarily increasing the ALLL in excess of amounts supported under GAAP.<sup>23</sup>

23. It is inappropriate to use a "standard percentage" as the sole determinant for the amount to be reported as the ALLL on the balance sheet. Moreover, an institution should not simply default to a peer ratio or a "standard percentage" after determining an appropriate level of ALLL under its methodology. However, there may be circumstances when an institution's ALLL methodology and credit risk identification

### *Estimated Credit Losses in Credit Related Accounts*

Typically, institutions evaluate and estimate credit losses for off-balance-sheet credit exposures at the same time that they estimate credit losses for loans. While a similar process should be followed to support loss estimates related to off-balance-sheet exposures, these estimated credit losses are not recorded as part of the ALLL. When the conditions for accrual of a loss under FAS 5 are met, an institution should maintain and report as a separate liability account, an allowance that is appropriate to cover estimated credit losses on off-balance-sheet loan commitments, standby letters of credit, and guarantees. In addition, recourse liability accounts (that arise from recourse obligations on any transfers of loans that are reported as sales in accordance with GAAP) should be reported in regulatory reports as liabilities that are separate and distinct from both the ALLL and the allowance for credit losses on off-balance-sheet credit exposures.

When accrued interest and fees are reported separately on an institution's balance sheet from the related loan balances (that is, as other assets), the institution should maintain an appropriate valuation allowance, determined in accordance with GAAP, for amounts that are not likely to be collected unless management has placed the underlying loans in nonaccrual status and reversed previously accrued interest and fees.<sup>24</sup>

### *Responsibilities of Examiners*

Examiners should assess the credit quality of an institution's loan portfolio, the appropriateness of its ALLL methodology and documentation, and the appropriateness of the reported ALLL in the institution's regulatory reports. In their review and classification or grading of the loan portfolio, examiners should consider all significant factors that affect the collectibility of the

systems are not reliable. Absent reliable data of its own, management may seek data that could be used as a short-term proxy for the unavailable information (for example, an industry average loss rate for loans with similar risk characteristics). This is only appropriate as a short-term remedy until the institution creates a viable system for estimating credit losses within its loan portfolio.

24. See the Call Report instructions for further guidance on placing a loan in nonaccrual status.

portfolio, including the value of any collateral. In reviewing the appropriateness of the ALLL, examiners should do the following:

- Consider the effectiveness of board oversight as well as the quality of the institution's loan review system and management in identifying, monitoring, and addressing asset quality problems. This will include a review of the institution's loan review function and credit grading system. Typically, this will involve testing a sample of the institution's loans. The sample size generally varies and will depend on the nature or purpose of the examination.<sup>25</sup>
- Evaluate the institution's ALLL policies and procedures and assess the methodology that management uses to arrive at an overall estimate of the ALLL, including whether management's assumptions, valuations, and judgments appear reasonable and are properly supported. If a range of credit losses has been estimated by management, evaluate the reasonableness of the range and management's best estimate within the range. In making these evaluations, examiners should ensure that the institution's historical loss experience and all significant qualitative or environmental factors that affect the collectibility of the portfolio (including changes in the quality of the institution's loan review function and the other factors previously discussed) have been appropriately considered and that management has appropriately applied GAAP, including FAS 114 and FAS 5.
- Review management's use of loss estimation models or other loss estimation tools to ensure that the resulting estimated credit losses are in conformity with GAAP.
- Review the appropriateness and reasonableness of the overall level of the ALLL. In some instances this may include a quantitative analysis (for example, using the types of ratio analysis previously discussed) as a pre-

liminary check on the reasonableness of the ALLL. This quantitative analysis should demonstrate whether changes in the key ratios from prior periods are reasonable based on the examiner's knowledge of the collectibility of loans at the institution and its current environment.

- Review the ALLL amount reported in the institution's regulatory reports and financial statements and ensure these amounts reconcile to its ALLL analyses. There should be no material differences between the consolidated loss estimate, as determined by the ALLL methodology, and the final ALLL balance reported in the financial statements. Inquire about reasons for any material differences between the results of the institution's ALLL analyses and the institution's reported ALLL to determine whether the differences can be satisfactorily explained.
- Review the adequacy of the documentation and controls maintained by management to support the appropriateness of the ALLL.
- Review the interest and fee income accounts associated with the lending process to ensure that the institution's net income is not materially misstated.<sup>26</sup>

As noted in the "Responsibilities of the Board of Directors and Management" section of this policy statement, when assessing the appropriateness of the ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of management judgment. Even when an institution maintains sound loan administration and collection procedures and an effective loan review system and controls, its estimate of credit losses is not a single precise amount due to the wide range of qualitative or environmental factors that must be considered.

An institution's ability to estimate credit losses on specific loans and groups of loans should improve over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners should generally accept management's estimates when assessing the appropriateness of the

25. In an examiner's review of an institution's loan review system, the examiner's loan classifications or credit grades may differ from those of the institution's loan review system. If the examiner's evaluation of these differences indicates problems with the loan review system, especially when the loan classification or credit grades assigned by the institution are more liberal than those assigned by the examiner, the institution would be expected to make appropriate adjustments to the assignment of its loan classifications or credit grades to the loan portfolio and to its estimated credit losses. Furthermore, the institution would be expected to improve its loan review system. (This policy statement's attachment 1 discusses effective loan review systems.)

26. As noted previously, accrued interest and fees on loans that have been reported as part of the respective loan balances on the institution's balance sheet should be evaluated for estimated credit losses. The accrual of the interest and fee income should also be considered. Refer to GAAP and the Call Report instructions for further guidance on income recognition.

institution's reported ALLL, and not seek adjustments to the ALLL, when management has—

- maintained effective loan review systems and controls for identifying, monitoring, and addressing asset quality problems in a timely manner;
- analyzed all significant qualitative or environmental factors that affect the collectibility of the portfolio as of the evaluation date in a reasonable manner;
- established an acceptable ALLL evaluation process for both individual loans and groups of loans that meets the GAAP requirements for an appropriate ALLL; and
- incorporated reasonable and properly supported assumptions, valuations, and judgments into the evaluation process.

If the examiner concludes that the reported ALLL level is not appropriate or determines that the ALLL evaluation process is based on the results of an unreliable loan review system or is otherwise deficient, recommendations for correcting these deficiencies, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination. The examiner's comments should cite any departures from GAAP and any contraventions of this policy statement and the 2001 policy statement, as applicable. Additional supervisory action may also be taken based on the magnitude of the observed shortcomings in the ALLL process, including the materiality of any error in the reported amount of the ALLL.

### ALLL Level Reflected in Regulatory Reports

The agencies believe that an ALLL established in accordance with this policy statement and the 2001 policy statement, as applicable, falls within the range of acceptable estimates determined in accordance with GAAP. When the reported amount of an institution's ALLL is not appropriate, the institution will be required to adjust its ALLL by an amount sufficient to bring the ALLL reported on its Call Report to an appropriate level as of the evaluation date. This adjustment should be reflected in the current period provision or through the restatement of prior period provisions, as appropriate in the circumstances.

### Attachment 1 to Policy Statement—Loan Review Systems

The nature of loan review systems may vary based on an institution's size, complexity, loan types, and management practices.<sup>27</sup> For example, a loan review system may include components of a traditional loan review function that is independent of the lending function, or it may place some reliance on loan officers. In addition, the use of the term "loan review system" can refer to various responsibilities assigned to credit administration, loan administration, a problem loan workout group, or other areas of an institution. These responsibilities may range from administering the internal problem loan reporting process to maintaining the integrity of the loan classification or credit grading process (for example, ensuring that timely and appropriate changes are made to the loan classifications or credit grades assigned to loans) and coordinating the gathering of the information necessary to assess the appropriateness of the ALLL. Additionally, some or all of this function may be outsourced to a qualified external loan reviewer. Regardless of the structure of the loan review system in an institution, an effective loan review system should have, at a minimum, the following objectives:

- to promptly identify loans with potential credit weaknesses;
- appropriately grade or adversely classify loans, especially those with well-defined credit weaknesses that jeopardize repayment, so that timely action can be taken and credit losses can be minimized;
- identify relevant trends that affect the collectibility of the portfolio and isolate segments of the portfolio that are potential problem areas;
- assess the adequacy of and adherence to

27. The loan review function is not intended to be performed by an institution's internal audit function. However, as discussed in the banking agencies' March 2003 Interagency Policy Statement on the Internal Audit Function and Its Outsourcing, some institutions seek to coordinate the internal audit function with several risk monitoring functions such as loan review. The policy statement notes that coordination of loan review with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better utilize available resources, and enhance the institution's ability to comprehensively manage risk. However, the internal audit function should maintain the ability to independently audit other risk monitoring functions, including loan review, without impairing its independence with respect to these other functions.



internal credit policies and loan administration procedures and to monitor compliance with relevant laws and regulations;

- evaluate the activities of lending personnel including their compliance with lending policies and the quality of their loan approval, monitoring, and risk assessment;
- provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio; and
- provide management with accurate and timely credit quality information for financial and regulatory reporting purposes, including the determination of an appropriate ALLL.

### *Loan Classification or Credit-Grading Systems*

The foundation for any loan review system is accurate and timely loan classification or credit grading, which involves an assessment of credit quality and leads to the identification of problem loans. An effective loan classification or credit grading system provides important information on the collectibility of the portfolio for use in the determination of an appropriate level for the ALLL.

Regardless of the type of loan review system employed, an effective loan classification or credit grading framework generally places primary reliance on the institution's lending staff to identify emerging loan problems. However, given the importance and subjective nature of loan classification or credit grading, the judgment of an institution's lending staff regarding the assignment of particular classification or grades to loans should be subject to review by: (1) peers, superiors, or loan committee(s); (2) an independent, qualified part-time or full-time employee(s); (3) an internal department staffed with credit review specialists; or (4) qualified outside credit review consultants. A loan classification or credit grading review that is independent of the lending function is preferred because it typically provides a more objective assessment of credit quality. Because accurate and timely loan classification or credit grading is a critical component of an effective loan review system, each institution should ensure that its loan review system includes the following attributes:

- a formal loan classification or credit grading

system in which loan classifications or credit grades reflect the risk of default and credit losses and for which a written description is maintained, including a discussion of the factors used to assign appropriate classifications or credit grades to loans;<sup>28</sup>

- an identification or grouping of loans that warrant the special attention of management<sup>29</sup> or other designated "watch lists" of loans that management is more closely monitoring;
- documentation supporting the reasons why particular loans merit special attention or received a specific adverse classification or credit grade and management's adherence to approved workout plans;
- a mechanism for direct, periodic, and timely reporting to senior management and the board of directors on the status of loans identified as meriting special attention or adversely classified or graded and the actions taken by management; and
- appropriate documentation of the institution's historical loss experience for each of the groups of loans with similar risk characteristics into which it has segmented its loan portfolio.<sup>30</sup>

### *Elements of Loan Reviews*

Each institution should have a written policy that is reviewed and approved at least annually by the board of directors to evidence its support of and commitment to maintaining an effective loan review system. The loan review policy should address the following elements that are described in more detail below: the qualifications and independence of loan review person-

28. A bank may have a loan classification or credit grading system that differs from the framework used by the banking agencies. However, each institution that maintains a loan classification or credit grading system that differs from the banking agencies' framework should maintain documentation that translates its system into the framework used by the banking agencies. This documentation should be sufficient to enable examiners to reconcile the totals for the various loan classifications or credit grades under the institution's system to the banking agencies' categories.

29. For banks, loans that have potential weaknesses that deserve management's close attention are designated "special mention" loans.

30. In particular, institutions with large and complex loan portfolios are encouraged to maintain records of their historical loss experience for credits in each of the categories in their loan classification or credit grading framework. For banks, these categories should either be those used by, or should be categories that can be translated into those used by, the banking agencies.

nel; the frequency, scope, and depth of reviews; the review of findings and follow-up; and work-paper and report distribution.

*Qualifications of loan review personnel.* Persons involved in the loan review or credit grading function should be qualified based on their level of education, experience, and extent of formal credit training. They should be knowledgeable in both sound lending practices and the institution's lending guidelines for the types of loans offered by the institution. In addition, they should be knowledgeable of relevant laws and regulations affecting lending activities.

*Independence of loan review personnel.* An effective loan review system uses both the initial identification of emerging problem loans by loan officers and other line staff, and the credit review of loans by individuals independent of the credit approval process. An important requirement for an effective system is to place responsibility on loan officers and line staff for continuous portfolio analysis and prompt identification and reporting of problem loans. Because of frequent contact with borrowers, loan officers and line staff can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid overreliance upon loan officers and line staff for identification of problem loans. Institutions should ensure that loans are also reviewed by individuals who do not have control over the loans they review and who are not part of, and are not influenced by anyone associated with, the loan approval process.

While larger institutions typically establish a separate department staffed with credit review specialists, cost and volume considerations may not justify such a system in smaller institutions. In some smaller institutions, an independent committee of outside directors may fill this role. Whether or not the institution has an independent loan review department, the loan review function should report *directly* to the board of directors or a committee thereof (although senior management may be responsible for appropriate administrative functions so long as they do not compromise the independence of the loan review function).

Some institutions may choose to outsource the credit review function to an independent outside party. However, the responsibility for maintaining a sound loan review process cannot be delegated to an outside party. Therefore,

institution personnel who are independent of the lending function should assess control risks, develop the credit review plan, and ensure appropriate follow-up of findings. Furthermore, the institution should be mindful of special requirements concerning independence should it consider outsourcing the credit review function to its external auditor.

*Frequency of reviews.* Loan review personnel should review significant credits<sup>31</sup> at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality in a particular loan, loan product, or group of loans. Optimally, the loan review function can be used to provide useful continual feedback on the effectiveness of the lending process in order to identify any emerging problems. A system of ongoing or periodic portfolio reviews is particularly important to the ALLL determination process because this process is dependent on the accurate and timely identification of problem loans.

*Scope of reviews.* Reviews by loan review personnel should cover all loans that are significant and other loans that meet certain criteria. Management should document the scope of its reviews and ensure that the percentage of the portfolio selected for review provides reasonable assurance that the results of the review have identified any credit quality deterioration and other unfavorable trends in the portfolio and reflect its quality as a whole. Management should also consider industry standards for loan review coverage consistent with the size and complexity of its loan portfolio and lending operations to verify that the scope of its reviews is appropriate. The institution's board of directors should approve the scope of loan reviews on an annual basis or when any significant interim changes to the scope of reviews are made. Reviews typically include—

- loans over a predetermined size;
- a sufficient sample of smaller loans;
- past due, nonaccrual, renewed, and restructured loans;
- loans previously adversely classified or graded and loans designated as warranting the special

31. Significant credits in this context may or may not be loans individually evaluated for impairment under FAS 114.

attention of management<sup>32</sup> by the institution or its examiners;

- insider loans; and
- loans constituting concentrations of credit risk and other loans affected by common repayment factors.

*Depth of reviews.* Reviews should analyze a number of important aspects of the loans selected for review, including—

- credit quality, including underwriting and borrower performance;
- sufficiency of credit and collateral documentation;
- proper lien perfection;
- proper approval by the loan officer and loan committee(s);
- adherence to any loan agreement covenants;
- compliance with internal policies and procedures (such as aging, nonaccrual, and classification or grading policies) and laws and regulations; and
- appropriate identification of individually impaired loans, measurement of estimated loan impairment, and timeliness of charge-offs.

Furthermore, these reviews should consider the appropriateness and timeliness of the identification of problem loans by loan officers.

*Review of findings and follow-up.* Loan review personnel should discuss all noted deficiencies and identified weaknesses and any existing or planned corrective actions, including time frames for correction, with appropriate loan officers and department managers. Loan review personnel should then review these findings and corrective actions with members of senior management. All noted deficiencies and identified weaknesses that remain unresolved beyond the scheduled time frames for correction should be promptly reported to senior management and the board of directors.

Credit classification or grading differences between loan officers and loan review personnel should be resolved according to a prearranged process. That process may include formal appeals procedures and arbitration by an independent party or may require default to the assigned classification or grade that indicates lower credit quality. If an outsourced credit review concludes

that a borrower is less creditworthy than is perceived by the institution, the lower credit quality classification or grade should prevail unless internal parties identify additional information sufficient to obtain the concurrence of the outside reviewer or arbiter on the higher credit quality classification or grade.

*Workpaper and report distribution.* The loan review function should prepare a list of all loans reviewed (including the date of the review) and documentation (including a summary analysis) that substantiates the grades or classifications assigned to the loans reviewed. A report that summarizes the results of the loan review should be submitted to the board of directors at least quarterly.<sup>33</sup> In addition to reporting current credit quality findings, comparative trends can be presented to the board of directors that identify significant changes in the overall quality of the portfolio. Findings should also address the adequacy of and adherence to internal policies and procedures, as well as compliance with laws and regulations, in order to facilitate timely correction of any noted deficiencies.

## Attachment 2 to the Policy Statement—International Transfer Risk Considerations

With respect to international transfer risk, an institution with cross-border exposures should support its determination of the appropriateness of its ALLL by performing an analysis of the transfer risk, commensurate with the size and composition of the institution's exposure to each country. Such analyses should take into consideration the following factors, as appropriate:

- the institution's loan portfolio mix for each country (for example, types of borrowers, loan maturities, collateral, guarantees, special credit facilities, and other distinguishing factors);
- the institution's business strategy and its debt management plans for each country;
- each country's balance of payments position;
- each country's level of international reserves;
- each country's established payment performance record and its future debt servicing prospects;

<sup>33</sup> The board of directors should be informed more frequently than quarterly when material adverse trends are noted.

<sup>32</sup> See footnote 29.



- 
- each country's socio-political situation and its effect on the adoption or implementation of economic reforms, in particular those affecting debt servicing capacity;
  - each country's current standing with multilateral and official creditors;
  - the status of each country's relationships with other creditors, including institutions; and
  - the most recent evaluations distributed by the banking agencies' Interagency Country Exposure Review Committee.

# Allowance for Loan and Lease Losses

## Examination Objectives

Effective date November 1995

## Section 2070.2

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

# Allowance for Loan and Lease Losses

## Examination Procedures

Effective date November 1999

## Section 2070.3

1. If selected for implementation, complete or update the Allowance for Loan and Lease Losses section of the Internal Control Questionnaire. To do so, obtain a description of the methods and procedures employed by management to determine the adequacy of the bank's allowance for loan and lease losses and the supporting records maintained.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures and obtain a listing of any audit deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if appropriate corrections have been made.
4. Obtain or prepare an analysis of the allowance for loan and lease losses (valuation reserve) and the related deferred tax and capital accounts (in prior years referred to as the deferred tax and contingency portions of the reserve) for the period from the last examination date to the current one. Agree beginning and ending balances to the general ledger and review the appropriateness of changes in those accounts.
5. Obtain from the appropriate examiner a list of problem loans as of the examination date, that is, loans which are or may become less than 100 percent collectible, possess more than the normal degree of credit risk, are past due, or require more than normal management supervision.
6. Obtain from the appropriate examiner a detailed list of classified loans identified in the various loan departments.
7. Determine whether the reserve for possible loan losses has been adjusted through the most recent quarter and, if not, suggest that management make such adjustment.
8. If, in the opinion of management, significant changes in the collectibility of loans have occurred since the allowance was last adjusted, suggest that management adjust the allowance through examination date.
9. Evaluate management's determination of the amount necessary to adequately provide for estimated loan losses as of the examination date by considering the following:
  - a. known probable losses as determined by a review of the lists of loans obtained in steps 5 and 6 and other pertinent information
  - b. information included in the Uniform Bank Performance Report including—
    - historical losses as a percentage of loans outstanding and other relevant factors; and
    - comparison of the allowance ratios of banks of similar loan portfolio size and composition
  - c. other procedures necessary in the circumstances
10. Review the following items with appropriate management personnel, or prepare a memo to other examining personnel, for their use in reviewing with management:
  - a. internal control exceptions and deficiencies in or noncompliance with written policies, practices, and procedures
  - b. uncorrected audit deficiencies
  - c. inadequate allowance for possible loan and lease losses, if any
11. Request that management make appropriate adjustments to the allowance for loan and lease losses.
  - a. Determine the materiality of the change and the need to file amended financial reports.
  - b. Provide information to the examiner reviewing regulatory reports, if appropriate.
12. Prepare comments for the examination report regarding the allowance for loan and lease losses, and include any deficiencies reviewed with management and any remedial actions recommended.
13. Update the workpapers with any information that will facilitate future examinations.

# Allowance for Loan and Lease Losses

## Internal Control Questionnaire

Effective date December 1986

Section 2070.4

Review the bank's internal controls, policies, practices and procedures relating to the allowance for loan and lease losses (valuation reserve) and the determination of its adequacy. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow-charts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies which:
  - a. Establish criteria for determining when a loan is to be charged-off?
  - b. Establish procedures for charging off loans?
  - c. Establish procedures for periodically reviewing and documenting the adequacy of the valuation portion of the allowance?
  - d. Define collection efforts to be undertaken after a loan is charged-off?

### LOAN CHARGE-OFFS

- \*2. Is the preparation and posting of any subsidiary records of loans charged-off performed or reviewed by persons who do not also:
  - a. Issue official checks and drafts?
  - b. Handle cash?
- \*3. Are all loans charged-off reviewed and approved by the board of directors as evidenced by the minutes of board meetings?
- \*4. Are notes for loans charged-off maintained under dual custody?
5. Are collection efforts continued for loans charged-off until the potential for recovery is exhausted?
6. Are periodic progress reports prepared and reviewed by appropriate management personnel for all loans charged-off for which collection efforts are continuing?

7. Are adequate procedures in effect relative to recoveries?

### OTHER

- \*8. Does management review the adequacy of the valuation portion of the allowance and make necessary adjustments prior to preparing public financial statements (at a minimum, on a quarterly basis)?
9. Does management's review encompass and give adequate consideration to:
  - a. Past loan loss experience and other pertinent historical data?
  - b. Assessment of the effectiveness of lending policies and procedures?
  - c. Identification, on an individual loan basis, of significant potential weaknesses within the current loan portfolio and an estimate of related amount of loss?
  - d. Changes in the character of the loan portfolio?
  - e. Current economic conditions?
  - f. Amount of past-due loans on which interest is not being collected in accordance with the terms of the loans, and loans whose terms have been modified by reducing interest rates or deferring interest?
  - g. Other information appropriate to the circumstances (if so, explain briefly)?
10. Does management retain documentation of their review?
11. Is accrued interest on loans charged-off also charged-off against the allowance account or reversed against interest income, as appropriate?

### CONCLUSION

12. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

13. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

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## OVERVIEW

A supplemental interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions<sup>1</sup> was issued by the Federal Financial Institutions Examination Council (FFIEC) on July 2, 2001.<sup>2</sup> The policy statement clarifies the agencies' expectations for documentation that supports the ALLL methodology. Additionally, the statement emphasizes the need for appropriate ALLL policies and procedures, which should include an effective loan-review system. The guidance also provides examples of appropriate supporting documentation, as well as illustrations on how to implement this guidance. The policy statement, by its terms, applies only to depository institutions insured by the Federal Deposit Insurance Corporation. Examiners should apply the policy during the examination of state member banks and their subsidiaries. (See SR-01-17.)

The guidance requires that a financial institution's ALLL methodology be in accordance with generally accepted accounting principles (GAAP) and all outstanding supervisory guidance. An ALLL methodology should be systematic, consistently applied, and auditable. The methodology should be validated periodically and modified to incorporate new events or findings, as needed. The guidance specifies that management, under the direction of the board of directors, should implement appropriate procedures and controls to ensure compliance with the institution's ALLL policies and procedures. Institution management should (1) segment the portfolio to evaluate credit risks; (2) select loss rates that best reflect the probable loss; and (3) be responsive to changes in the organization, the economy, or the lending environment by changing the methodology, when appropriate. Furthermore, supporting information should be included on summary schedules, whenever feasible. Under this policy, institutions with less complex loan products or portfolios, such as community banks, may use a more streamlined approach to implement this guidance.

The policy statement is consistent with the Federal Reserve's long-standing policy to promote strong internal controls over an institution's ALLL process. In this regard, the new policy statement recognizes that determining an appropriate allowance involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. In accordance with GAAP, an institution should record its best estimate within the range of credit losses.

The policy statement is provided below. Some wording has been slightly modified for this manual, as indicated by asterisks or text enclosed in brackets. Some footnotes have also been renumbered.

## 2001 POLICY STATEMENT ON ALLL METHODOLOGIES AND DOCUMENTATION

Boards of directors of banks \* \* \* are responsible for ensuring that their institutions have controls in place to consistently determine the allowance for loan and lease losses (ALLL) in accordance with the institutions' stated policies and procedures, generally accepted accounting principles (GAAP), and ALLL supervisory guidance.<sup>3</sup> To fulfill this responsibility, boards of directors instruct management to develop and maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan losses. Management should create and implement suitable policies and procedures to communicate the ALLL process internally to all applicable personnel. Regardless of who develops and implements these policies, procedures, and underlying controls, the board of directors should assure themselves that the policies specifically address the institution's unique goals, systems, risk profile, personnel, and other resources before approving them. Additionally, by creating an environment that encourages personnel to fol-

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1. See 66 *Fed. Reg.* 35629–35639 (July 6, 2001).

2. The guidance was developed in consultation with Securities and Exchange Commission staff, who are issuing parallel guidance in the form of Staff Accounting Bulletin No. 102.

3. The actual policy statement includes a bibliography that lists applicable ALLL GAAP guidance, interagency statements, and other reference materials that may assist in understanding and implementing an ALLL in accordance with GAAP. See the appendix for additional information on applying GAAP to determine the ALLL.

low these policies and procedures, management improves procedural discipline and compliance.

The determination of the amounts of the ALLL and provisions for loan and lease losses should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the reporting date. The amounts reported each period for the provision for loan and lease losses and the ALLL should be reviewed and approved by the board of directors. To ensure the methodology remains appropriate for the institution, the board of directors should have the methodology periodically validated and, if appropriate, revised. Further, the audit committee<sup>4</sup> should oversee and monitor the internal controls over the ALLL-determination process.<sup>5</sup>

The [Federal Reserve and other] banking agencies<sup>6</sup> have long-standing examination policies that call for examiners to review an institution's lending and loan-review functions and recommend improvements, if needed. Additionally, in 1995 and 1996, the banking agencies adopted interagency guidelines establishing standards for safety and soundness, pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act).<sup>7</sup> The interagency asset-quality guidelines and [this guidance will assist] an institution in estimating and establishing a sufficient ALLL supported by adequate documentation, as required under the FDI Act. Additionally, the guidelines require operational and managerial standards that are appropriate for an institution's size and the nature and scope of its activities.

For financial-reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined

in accordance with GAAP. GAAP requires that allowances be well documented, with clear explanations of the supporting analyses and rationale.<sup>8</sup> This [2001] policy statement describes but does not increase the documentation requirements already existing within GAAP. Failure to maintain, analyze, or support an adequate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound banking practice.<sup>9</sup>

This guidance [the 2001 policy statement] applies equally to all institutions, regardless of the size. However, institutions with less complex lending activities and products may find it more efficient to combine a number of procedures (e.g., information gathering, documentation, and internal-approval processes) while continuing to ensure the institution has a consistent and appropriate methodology. Thus, much of the supporting documentation required for an institution with more complex products or portfolios may be combined into fewer supporting documents in an institution with less complex products or portfolios. For example, simplified documentation can include spreadsheets, checklists, and other summary documents that many institutions currently use. Illustrations A and C provide specific examples of how less complex institutions may determine and document portions of their loan-loss allowance.

## Documentation Standards

Appropriate written supporting documentation for the loan-loss provision and allowance facili-

4. All institutions are encouraged to establish audit committees; however, at small institutions without audit committees, the board of directors retains this responsibility.

5. Institutions and their auditors should refer to Statement on Auditing Standards No. 61, "Communication with Audit Committees" (as amended by Statement on Auditing Standards No. 90, "Audit Committee Communications"), which requires certain discussions between the auditor and the audit committee. These discussions should include items, such as accounting policies and estimates, judgments, and uncertainties that have a significant impact on the accounting information included in the financial statements.

6. The [other] banking agencies are the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

7. Institutions should refer to the guidelines \*\*\* for state member banks, appendix D to part 208\*\*\*.

8. The documentation guidance within this [2001] policy statement is predominantly based upon the GAAP guidance from Financial Accounting Standards Board (FASB) Statement No. 5 and No. 114 (FAS 5 and FAS 114, respectively); Emerging Issues Task Force Topic No. D-80 (EITF Topic D-80 and attachments), "Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio" (which includes the *Viewpoints* article—an article issued in 1999 by FASB staff providing guidance on certain issues regarding the ALLL, particularly on the application of FAS 5 and FAS 114 and how these statements interrelate); Chapter 7, "Credit Losses," the American Institute of Certified Public Accountants' (AICPA) Audit and Accounting Guide, *Banks and Savings Institutions*, 2000 edition (AICPA Audit Guide); and the Securities and Exchange Commission's (SEC) Financial Reporting Release No. 28 (FRR 28).

9. Failure to maintain adequate supporting documentation does not relieve an institution of its obligation to record an appropriate ALLL.

tates review of the ALLL process and reported amounts, builds discipline and consistency into the ALLL-determination process, and improves the process for estimating loan and lease losses by helping to ensure that all relevant factors are appropriately considered in the ALLL analysis. An institution should document the relationship between the findings of its detailed review of the loan portfolio and the amount of the ALLL and the provision for loan and lease losses reported in each period.<sup>10</sup>

At a minimum, institutions should maintain written supporting documentation for the following decisions, strategies, and processes:

- policies and procedures—
  - over the systems and controls that maintain an appropriate ALLL and
  - over the ALLL methodology
- loan-grading system or process
- summary or consolidation of the ALLL balance
- validation of the ALLL methodology
- periodic adjustments to the ALLL process

## Policies and Procedures

Financial institutions utilize a wide range of policies, procedures, and control systems in their ALLL process. Sound policies should be appropriately tailored to the size and complexity of the institution and its loan portfolio.

In order for an institution's ALLL methodology to be effective, the institution's written policies and procedures for the systems and controls that maintain an appropriate ALLL should address but not be limited to—

- the roles and responsibilities of the institution's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine, or review, as applicable, the ALLL to be reported in the financial statements;
- the institution's accounting policies for loans, [leases, and their loan losses], including the

policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;

- the description of the institution's systematic methodology, which should be consistent with the institution's accounting policies for determining its ALLL;<sup>11</sup> and
- the system of internal controls used to ensure that the ALLL process is maintained in accordance with GAAP and supervisory guidance.

An internal-control system for the ALLL-estimation process should—

- include measures to provide assurance regarding the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;
- reasonably assure that the institution's financial statements (including regulatory reports) are prepared in accordance with GAAP and ALLL supervisory guidance;<sup>12</sup> and
- include a well-defined loan-review process containing—
  - an effective loan-grading system that is consistently applied, identifies differing risk characteristics and loan-quality problems accurately and in a timely manner, and prompts appropriate administrative actions;
  - sufficient internal controls to ensure that all relevant loan-review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved; and
  - clear formal communication and coordination between an institution's credit-administration function, financial-reporting group, management, board of directors,

11. Further explanation is presented in the "Methodology" section that appears below.

12. In addition to the supporting documentation requirements for financial institutions, as described in interagency asset-quality guidelines, public companies are required to comply with the books and records provisions of the Securities Exchange Act of 1934 (Exchange Act). Under sections 13(b)(2)–(7) of the Exchange Act, registrants must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. See also SEC Staff Accounting Bulletin No. 99, *Materiality*.

10. This position is fully described in the SEC's FRR 28, in which the SEC indicates that the books and records of public companies engaged in lending activities should include documentation of the rationale supporting each period's determination that the ALLL and provision amounts reported were adequate.



and others who are involved in the ALLL-determination or -review process, as applicable (e.g., written policies and procedures, management reports, audit programs, and committee minutes).

## Methodology

An ALLL methodology is a system that an institution designs and implements to reasonably estimate loan and lease losses as of the financial statement date. It is critical that ALLL methodologies incorporate management's current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process.

An institution's ALLL methodology is influenced by institution-specific factors, such as an institution's size, organizational structure, business environment and strategy, management style, loan-portfolio characteristics, loan-administration procedures, and management information systems. However, there are certain common elements an institution should incorporate in its ALLL methodology. A summary of common elements is provided in [the appendix].<sup>13</sup>

### *Documentation of ALLL Methodology in Written Policies and Procedures*

An institution's written policies and procedures should describe the primary elements of the institution's ALLL methodology, including portfolio segmentation and impairment measurement. In order for an institution's ALLL methodology to be effective, the institution's written policies and procedures should describe the methodology—

- for segmenting the portfolio:
  - how the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.),
  - when a loan-grading system is used to segment the portfolio:
    - the definitions of each loan grade,
    - a reconciliation of the internal loan grades to supervisory loan grades, and
    - the delineation of responsibilities for the loan-grading system.

- for determining and measuring impairment under FAS 114:
  - the methods used to identify loans to be analyzed individually;
  - for individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including—
    - procedures describing the impairment-measurement techniques available and
    - steps performed to determine which technique is most appropriate in a given situation.
  - the methods used to determine whether and how loans individually evaluated under FAS 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under FAS 5.
- for determining and measuring impairment under FAS 5—
  - how loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);
  - how loss rates are determined (e.g., historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and
  - descriptions of qualitative factors (e.g., industry, geographical, economic, and political factors) that may affect loss rates or other loss measurements.

The supporting documents for the ALLL may be integrated in an institution's credit files, loan-review reports or worksheets, board of directors' and committee meeting minutes, computer reports, or other appropriate documents and files.

### ALLL Under FAS 114

An institution's ALLL methodology related to FAS 114 loans begins with the use of its normal loan-review procedures to identify whether a loan is impaired as defined by the accounting standard. Institutions should document—

- the method and process for identifying loans to be evaluated under FAS 114 and

<sup>13</sup> Also, refer to paragraph 7.05 of the AICPA Audit Guide.

- the analysis that resulted in an impairment decision for each loan and the determination of the impairment-measurement method to be used (i.e., present value of expected future cash flows, fair value of collateral less costs to sell, or the loan's observable market price).

Once an institution has determined which of the three available measurement methods to use for an impaired loan under FAS 114, it should maintain supporting documentation as follows:

- When using the present-value-of-expected-future-cash-flows method—
  - the amount and timing of cash flows,
  - the effective interest rate used to discount the cash flows, and
  - the basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions.
- When using the fair-value-of-collateral method—
  - how fair value was determined, including the use of appraisals, valuation assumptions, and calculations,
  - the supporting rationale for adjustments to appraised values, if any,
  - the determination of costs to sell, if applicable, and

- appraisal quality, and the expertise and independence of the appraiser.
- When using the observable-market-price-of-a-loan method—
  - the amount, source, and date of the observable market price.

Illustration A describes a practice used by a small financial institution to document its FAS 114 measurement of impairment using a comprehensive worksheet.<sup>14</sup> [Examples 1 and 2 provide examples of applying and documenting impairment-measurement methods under FAS 114. Some loans that are evaluated individually for impairment under FAS 114 may be fully collateralized and therefore require no ALLL. Example 3 presents an institution whose loan portfolio includes fully collateralized loans. It describes the documentation maintained by that institution to support its conclusion that no ALLL was needed for those loans.]

14. The [referenced] illustrations are presented to assist institutions in evaluating how to implement the guidance provided in this document. The methods described in the illustrations may not be suitable for all institutions and are not considered required processes or actions. For additional descriptions of key aspects of ALLL guidance, a series of [numbered examples is provided. These examples were included in appendix A of the policy statement as questions and answers. The wording of the examples has been slightly modified for this format.]

### Illustration A Documenting an ALLL Under FAS 114

#### *Comprehensive worksheet for the impairment-measurement process*

A small institution utilizes a comprehensive worksheet for each loan being reviewed individually under FAS 114. Each worksheet includes a description of why the loan was selected for individual review, the impairment-measurement technique used, the measurement calculation, a comparison to the current loan balance, and the amount of the ALLL for that loan. The rationale for the impairment-measurement technique used (e.g., present value of expected future cash flows, observable market price of the loan, fair value of the collateral) is also described on the worksheet.

#### *Example 1: ALLL Under FAS 114— Measuring and Documenting Impairment*

*Facts.* Approximately one-third of Institution A's commercial loan portfolio consists of large-balance, nonhomogeneous loans. Due to their large individual balances, these loans meet the criteria under Institution A's policies and procedures for individual review for impairment under FAS 114. Upon review of the large-balance loans, Institution A determines that certain of the loans are impaired as defined by FAS 114.

*Analysis.* For the commercial loans reviewed under FAS 114 that are individually impaired, Institution A should measure and document the impairment on those loans. For those loans that are reviewed individually under FAS 114 and considered individually impaired, Institution A must use one of the methods for measuring impairment that is specified by FAS 114 (that is, the present value of expected future cash flows,

the loan's observable market price, or the fair value of collateral).

An impairment-measurement method other than the methods allowed by FAS 114 cannot be used. For the loans considered individually impaired under FAS 114, under the circumstances described above, it would not be appropriate for Institution A to choose a measurement method not prescribed by FAS 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its commercial loans for the past five years.

Institution A should maintain, as sufficient, objective evidence, written documentation to support its measurement of loan impairment under FAS 114. If it uses the present value of expected future cash flows to measure impairment of a loan, it should document (1) the amount and timing of cash flows, (2) the effective interest rate used to discount the cash flows, and (3) the basis for the determination of cash flows, including consideration of current environmental factors<sup>15</sup> and other information reflecting past events and current conditions. If Institution A uses the fair value of collateral to measure impairment, it should document (1) how it determined the fair value, including the use of appraisals, valuation assumptions and calculations; (2) the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable; (3) appraisal quality; and (4) the expertise and independence of the appraiser. Similarly, Institution A should document the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

*Example 2: ALLL Under FAS 114—  
Measuring Impairment for a  
Collateral-Dependent Loan*

*Facts.* Institution B has a \$10 million loan outstanding to Company X that is secured by real estate, which Institution B individually evaluates under FAS 114 due to the loan's size. Company X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Institution B determines that its loan to

Company X is impaired, as defined by FAS 114. Because the loan is collateral dependent, Institution B measures impairment of the loan based on the fair value of the collateral. Institution B determines that the most recent valuation of the collateral was performed by an appraiser 18 months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was \$12 million.

Institution B believes that certain of the assumptions that were used to value the collateral 18 months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit-review personnel at Institution B adjust certain of the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral.<sup>16</sup> After adjusting the collateral-valuation assumptions, the credit-review department determines that the current estimated fair value of the collateral, less costs to sell, is \$8 million. Given that the recorded investment in the loan is \$10 million, Institution B concludes that the loan is impaired by \$2 million and records an allowance for loan losses of \$2 million.

*Analysis.* Institution B should maintain documentation to support its determination of the allowance for loan losses of \$2 million for the loan to Company X. It should document that it measured impairment of the loan to Company X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be \$8 million. This documentation should include (1) the institution's rationale and basis for the \$8 million valuation, including the revised valuation assumptions it used; (2) the valuation calculation; and (3) the determination of costs to sell, if applicable. Because Institution B arrived at the valuation of \$8 million by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from \$12 million 18

15. Question 16 in Exhibit D-80A of EITF Topic D-80 and [its] attachments indicates that environmental factors include existing industry, geographical, economic, and political factors.

16. When reviewing collateral-dependent loans, Institution B may often find it more appropriate to obtain an updated appraisal to estimate the effect of current market conditions on the appraised value instead of internally estimating an adjustment.

months ago to \$8 million in the current period.<sup>17</sup>

### *Example 3: ALLL Under FAS 114—Fully Collateralized Loans*

**Facts.** Institution C has \$10 million in loans that are fully collateralized by highly rated debt securities with readily determinable market values. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to maintain a loan-to-value ratio with sufficient margin to absorb volatility in the securities' market prices. Institution C's collateral department has physical control of the debt securities through safekeeping arrangements. In addition, Institution C perfected its security interest in the collateral when the funds were originally distributed. On a quarterly basis, Institution C's credit-administration function determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. If there are any collateral deficiencies, Institution C notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Institution C has historically not incurred any material losses on these loans. Institution C believes these loans are fully collateralized and therefore does not maintain any ALLL balance for these loans.

**Analysis.** To adequately support its determina-

17. In accordance with the FFIEC's *Federal Register* notice, Implementation Issues Arising from FASB No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995 (60 *Fed. Reg.* 7966, February 10, 1995), impaired, collateral-dependent loans must be reported at the fair value of collateral, less costs to sell, in regulatory reports. This treatment is to be applied to all collateral-dependent loans, regardless of type of collateral.

tion that no allowance is needed for this group of loans, Institution C must maintain the following documentation:

- The management summary of the ALLL must include documentation indicating that, in accordance with the institution's ALLL policy, (1) Institution C has verified the collateral protection on these loans, (2) no probable loss has been incurred, and (3) no ALLL is necessary.
- The documentation in Institution C's loan files must include (1) the two independent market quotes obtained each quarter for each loan's collateral amount, (2) the documents evidencing the perfection of the security interest in the collateral and other relevant supporting documents, and (3) Institution C's ALLL policy, including guidance for determining when a loan is considered "fully collateralized," which would not require an ALLL. Institution C's policy should require the following factors to be considered and fully documented:
  - volatility of the market value of the collateral
  - recency and reliability of the appraisal or other valuation
  - recency of the institution's or third party's inspection of the collateral
  - historical losses on similar loans
  - confidence in the institution's lien or security position including appropriate—
    - type of security perfection (e.g., physical possession of collateral or secured filing);
    - filing of security perfection (i.e., correct documents and with the appropriate officials);
    - relationship to other liens; and
    - other factors as appropriate for the loan type.

## ALLL Under FAS 5

### *Segmenting the Portfolio*

For loans evaluated on a group basis under FAS 5, management should segment the loan portfolio by identifying risk characteristics that are common to groups of loans. Institutions typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Smaller institutions

that are involved in less complex activities often segment the portfolio into broad loan categories. This method of segmenting the portfolio is likely to be appropriate in only small institutions offering a narrow range of loan products. Larger institutions typically offer a more diverse and complex mix of loan products. Such institutions may start by segmenting the portfolio into major loan types but typically have more detailed information available that allows them to further segregate the portfolio into product-line segments based on the risk characteristics of each

portfolio segment. Regardless of the segmentation method used, an institution should maintain documentation to support its conclusion that the loans in each segment have similar attributes or characteristics.

As economic and other business conditions change, institutions often modify their business

strategies, which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. Illustration B presents an example in which an institution refined its segmentation method to more effectively consider risk factors and maintains documentation to support this change.

## Illustration B

### Documenting Segmenting Practices

#### *Documenting a refinement in a segmentation method*

An institution with a significant portfolio of consumer loans performed a review of its ALLL methodology. The institution had determined its ALLL based upon historical loss rates in the overall consumer portfolio. The ALLL methodology was validated by comparing actual loss rates (charge-offs) for the past two years to the estimated loss rates. During this process, the

institution decided to evaluate loss rates on an individual-product basis (e.g., auto loans, unsecured loans, or home equity loans). This analysis disclosed significant differences in the loss rates on different products. With this additional information, the methodology was amended in the current period to segment the portfolio by product, resulting in a better estimation of the loan losses associated with the portfolio. To support this change in segmentation practice, the credit-review committee records contain the analysis that was used as a basis for the change and the written report describing the need for the change.

Institutions use a variety of documents to support the segmentation of their portfolios. Some of these documents include—

- loan trial balances by categories and types of loans,
- management reports about the mix of loans in the portfolio,
- delinquency and nonaccrual reports, and
- a summary presentation of the results of an internal or external loan-grading review.

Reports generated to assess the profitability of a loan-product line may be useful in identifying areas in which to further segment the portfolio.

#### *Estimating Loss on Groups of Loans*

Based on the segmentation of the loan portfolio, an institution should estimate the FAS 5 portion of its ALLL. For those segments that require an ALLL,<sup>18</sup> the institution should estimate the loan and lease losses, on at least a quarterly basis, based upon its ongoing loan-review process and analysis of loan performance. The institution

should follow a systematic and consistently applied approach to select the most appropriate loss-measurement methods and support its conclusions and rationale with written documentation. Regardless of the methods used to measure losses, an institution should demonstrate and document that the loss-measurement methods used to estimate the ALLL for each segment are determined in accordance with GAAP as of the financial statement date.<sup>19</sup>

One method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect the institution's historical loan-loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time. If an institution does not have loss experience of its own, it may be appropriate to reference the loss experience of other institutions, provided that the institution demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the institution providing the loss experience.<sup>20</sup> Institutions should maintain supporting docu-

18. An example of a loan segment that does not generally require an ALLL is loans that are fully secured by deposits maintained at the lending institution.

19. Refer to paragraph 8(b) of FAS 5\*\*\*.

20. Refer to paragraph 23 of FAS 5.

mentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. If a range of loss is determined, institutions should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of loan losses. An example of how a small institution performs a comprehensive historical loss analysis is provided as the first item in Illustration C.

Before employing a loss-estimation model, an institution should evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, institutions that use loss-estimation models typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss-estimation tool, and the support for adjustments to the model or its results.

In developing loss measurements, institutions should consider the impact of current environmental factors and then document which factors were used in the analysis and how those factors affected the loss measurements. Factors that should be considered in developing loss measurements include the following:<sup>21</sup>

- levels of and trends in delinquencies and impaired loans

- levels of and trends in charge-offs and recoveries
- trends in volume and terms of loans
- effects of any changes in risk-selection and underwriting standards, and other changes in lending policies, procedures, and practices
- experience, ability, and depth of lending management and other relevant staff
- national and local economic trends and conditions
- industry conditions
- effects of changes in credit concentrations

For any adjustment of loss measurements for environmental factors, the institution should maintain sufficient, objective evidence to support the amount of the adjustment and to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements.

The second item in illustration C provides an example of how an institution adjusts its commercial real estate historical loss rates for changes in local economic conditions. Example 4 provides an example of maintaining supporting documentation for adjustments to portfolio-segment loss rates for an environmental factor related to an economic downturn in the borrower's primary industry. Example 5 describes one institution's process for determining and documenting an ALLL for loans that are not individually impaired but have characteristics indicating there are loan losses on a group basis.

21. Refer to paragraph 7.13 in the AICPA Audit Guide.

## Illustration C

### Documenting the Setting of Loss Rates

#### *Comprehensive loss analysis in a small institution*

A small institution determines its loss rates based on loss rates over a three-year historical period. The analysis is conducted by type of loan and is further segmented by originating branch office. The analysis considers charge-offs and recoveries in determining the loss rate. The institution also considers the loss rates for each loan grade and compares them to historical losses on similarly rated loans in arriving at the historical loss factor. The institution maintains supporting documentation for its loss-factor

analysis, including historical losses by type of loan, originating branch office, and loan grade for the three-year period.

#### *Adjustment of loss rates for changes in local economic conditions*

An institution develops a factor to adjust loss rates for its assessment of the impact of changes in the local economy. For example, when analyzing the loss rate on commercial real estate loans, the assessment identifies changes in recent commercial building occupancy rates. The institution generally finds the occupancy statistics to be a good indicator of probable losses on these types of loans. The institution maintains documentation that summarizes the relationship between current occupancy rates and its loss experience.

*Example 4: ALLL Under FAS 5—  
Adjusting Loss Rates*

*Facts.* Institution D's lending area includes a metropolitan area that is financially dependent upon the profitability of a number of manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices, and the manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the manufacturing businesses are experiencing financial difficulties and have recently announced downsize plans.

Although Institution D has yet to confirm an increase in its loss experience as a result of these events, management knows that it lends to a significant number of businesses and individuals whose repayment ability depends upon the long-term viability of the manufacturing businesses. Institution D's management has identified particular segments of its commercial and consumer customer bases that include borrowers highly dependent upon sales or salary from the manufacturing businesses. Institution D's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the ALLL. In this particular case, Institution D has experienced similar business and lending conditions in the past that it can compare to current conditions.

*Analysis.* Institution D should document its support for the loss-rate adjustments that result from considering these manufacturing firms' financial downturns. It should document its identification of the particular segments of its commercial and consumer loan portfolio for which it is probable that the manufacturing business' financial downturn has resulted in loan losses. In addition, it should document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments. As part of its documentation, Institution D should maintain copies of the documents supporting the

analysis, including relevant newspaper articles, economic reports, economic data, and notes from discussions with individual borrowers.

Since Institution D has had similar situations in the past, its supporting documentation should also include an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. As part of its effective ALLL methodology, a summary should be created of the amount and rationale for the adjustment factor, which management presents to the audit committee and board for their review and approval prior to the issuance of the financial statements.

*Example 5: ALLL Under FAS 5—  
Estimating Losses on Loans Individually  
Reviewed for Impairment but Not  
Considered Individually Impaired*

*Facts.* Institution E has outstanding loans of \$2 million to Company Y and \$1 million to Company Z, both of which are paying as agreed upon in the loan documents. The institution's ALLL policy specifies that all loans greater than \$750,000 must be individually reviewed for impairment under FAS 114. Company Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt-service requirements. In contrast, recent information indicates Company Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the institution's loan-grading system. Despite its concern, management believes Company Z will resolve its problems and determines that neither loan is individually impaired as defined by FAS 114.

Institution E segments its loan portfolio to estimate loan losses under FAS 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Company Y has risk characteristics similar to the loans included in Segment 1, and the loan to Company Z has risk characteristics similar to the loans included in Segment 2.<sup>22</sup>

In its determination of the ALLL under FAS 5, Institution E includes its loans to Company Y

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22. These groups of loans do not include any loans that have been individually reviewed for impairment under FAS 114 and determined to be impaired as defined by FAS 114.

and Company Z in the groups of loans with similar characteristics (i.e., Segment 1 for Company Y's loan and Segment 2 for Company Z's loan). Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors, provides a reasonable estimate of the institution's probable loan losses in these segments.

*Analysis.* Institution E should adequately document an ALLL under FAS 5 for these loans that were individually reviewed for impairment but

are not considered individually impaired. As part of its effective ALLL methodology, Institution E documents the decision to include its loans to Company Y and Company Z in its determination of its ALLL under FAS 5. It should also document the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. Institution E maintains documentation to support its method of estimating loan losses for Segment 1 and Segment 2, including the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates. The institution also maintains copies of the economic and other reports that provided source data.

## Consolidating the Loss Estimates

To verify that ALLL balances are presented fairly in accordance with GAAP and are auditable, management should prepare a document that summarizes the amount to be reported in the financial statements for the ALLL. The board of directors should review and approve this summary.

Common elements in such summaries include—

- the estimate of the probable loss or range of loss incurred for each category evaluated (e.g., individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);
- the aggregate probable loss estimated using the institution's methodology;
- a summary of the current ALLL balance;
- the amount, if any, by which the ALLL is to be adjusted;<sup>23</sup> and
- depending on the level of detail that supports the ALLL analysis, detailed subschedules of loss estimates that reconcile to the summary schedule.

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23. Subsequent to adjustments, there should be no material differences between the consolidated loss estimate, as determined by the methodology, and the final ALLL balance reported in the financial statements.

Illustration D describes how an institution documents its estimated ALLL by adding comprehensive explanations to its summary schedule.

Generally, an institution's review and approval process for the ALLL relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the ALLL methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e.g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a FAS 114 valuation based upon the fair value of collateral). It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel. Additionally, the summary should provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, management should document the nature of any adjustments and the underlying rationale for making the changes. This documentation should be provided to those making the final determination of the ALLL amount. Example 6 addresses the documentation of the final amount of the ALLL.



## Illustration D

### Summarizing Loss Estimates

*Descriptive comments added to the consolidated ALLL summary schedule*

To simplify the supporting documentation process and to eliminate redundancy, an institution adds detailed supporting information to its summary schedule. For example, this institution's board of directors receives, within the body of the ALLL summary schedule, a brief description of the institution's policy for selecting loans for evaluation under FAS 114. Additionally, the institution identifies which FAS 114 impairment-measurement method was used for each individually reviewed impaired loan. Other items on the schedule include a brief description of the loss factors for each segment of the loan portfolio, the basis for adjustments to loss rates, and explanations of changes in ALLL amounts from period to period, including cross-references to more detailed supporting documents.

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#### *Example 6: Consolidating the Loss Estimates—Documenting the Reported ALLL*

*Facts.* Institution F determines its ALLL using an established systematic process. At the end of each period, the accounting department prepares a summary schedule that includes the amount of each of the components of the ALLL, as well as the total ALLL amount, for review by senior management, the credit committee, and, ultimately, the board of directors. Members of senior management and the credit committee meet to discuss the ALLL. During these discussions, they identify changes that are required by GAAP to be made to certain of the ALLL

estimates. As a result of the adjustments made by senior management, the total amount of the ALLL changes. However, senior management (or its designee) does not update the ALLL summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original ALLL summary schedule that was reviewed by senior management and the credit committee, as well as a verbal explanation of the changes made by senior management and the credit committee when they met to discuss the loan-loss allowance.

*Analysis.* Institution F's documentation practices supporting the balance of its loan-loss allowance, as reported in its financial statements, are not in compliance with existing documentation guidance. An institution must maintain supporting documentation for the loan-loss allowance amount reported in its financial statements. As illustrated above, there may be instances in which ALLL reviewers identify adjustments that need to be made to the loan-loss estimates. The nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the ALLL balance should be documented. Appropriate documentation of the adjustments should be provided to the board of directors (or its designee) for review of the final ALLL amount to be reported in the financial statements. For institutions subject to external audit, this documentation should also be made available to the independent accountants. If changes frequently occur during management or credit committee reviews of the ALLL, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the institution uses.

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### Validating the ALLL Methodology

An institution's ALLL methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio. Thus, the institution's methodology should include procedures that adjust loss-estimation methods to reduce differences between estimated losses and actual subsequent charge-offs, as necessary.

To verify that the ALLL methodology is valid and conforms to GAAP and supervisory guid-

ance, an institution's directors should establish internal-control policies, appropriate for the size of the institution and the type and complexity of its loan products. These policies should include procedures for a review, by a party who is independent of the ALLL-estimation process, of the ALLL methodology and its application in order to confirm its effectiveness.

In practice, financial institutions employ numerous procedures when validating the reasonableness of their ALLL methodology and

determining whether there may be deficiencies in their overall methodology or loan-grading process. Examples are—

- a review of trends in loan volume, delinquencies, restructurings, and concentrations;
- a review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries;
- a review by a party that is independent of the ALLL-estimation process (this often involves the independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates); and
- an evaluation of the appraisal process of the underlying collateral. (This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.)

### *Supporting Documentation for the Validation Process*

Management usually supports the validation process with the workpapers from the ALLL-review function. Additional documentation often includes the summary findings of the independent reviewer. The institution's board of directors, or its designee, reviews the findings and acknowledges its review in its meeting minutes. If the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes should be maintained.

## Appendix—Application of GAAP

[This appendix was designated appendix B in the policy statement.] An ALLL recorded pursuant to GAAP is an institution's best estimate of the probable amount of loans and lease-financing receivables that it will be unable to collect based on current information and events.<sup>24</sup>

24. This appendix provides guidance on the ALLL and does not address allowances for credit losses for off-balance-sheet instruments (e.g., loan commitments, guarantees, and standby letters of credit). Institutions should record liabilities for these exposures in accordance with GAAP. Further guidance on this topic is presented in the American Institute of Certified Public Accountants' Audit and Accounting Guide,

A creditor should record an ALLL when the criteria for accrual of a loss contingency as set forth in GAAP have been met. Estimating the amount of an ALLL involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. An institution should record its best estimate within the range of loan losses.<sup>25</sup>

Under GAAP, Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" (FAS 5), provides the basic guidance for recognition of a loss contingency, such as the collectibility of loans (receivables), when it is probable that a loss has been incurred and the amount can be reasonably estimated. Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan" (FAS 114) provides more specific guidance about the measurement and disclosure of impairment for certain types of loans.<sup>26</sup> Specifically, FAS 114 applies to loans that are identified for evaluation on an individual basis. Loans are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement.

For individually impaired loans, FAS 114 provides guidance on the acceptable methods to measure impairment. Specifically, FAS 114 states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future principal and interest cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of collateral, if the loan is collateral dependent. When developing the estimate of expected future cash flows for a loan, an institution should

*Banks and Savings Institutions*, 2000 edition (AICPA Audit Guide). Additionally, this appendix does not address allowances or accounting for assets or portions of assets sold with recourse, which is described in Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—A Replacement of FASB Statement No. 125" (FAS 140).

25. Refer to FASB Interpretation No. 14, "Reasonable Estimation of the Amount of a Loss," and Emerging Issues Task Force Topic No. D-80, "Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio" (EITF Topic D-80).

26. EITF Topic D-80 includes additional guidance on the requirements of FAS 5 and FAS 114 and how they relate to each other.\*\*\*

consider all available information reflecting past events and current conditions, including the effect of existing environmental factors. The

following illustration provides an example of an institution estimating a loan's impairment when the loan has been partially charged off.

### Illustration

#### Interaction of FAS 114 with an Adversely Classified Loan, Partial Charge-Off, and the Overall ALLL

An institution determined that a collateral-dependent loan, which it identified for evaluation, was impaired. In accordance with FAS 114, the institution established an ALLL for the amount that the recorded investment in the loan exceeded the fair value of the underlying collateral, less costs to sell.

Consistent with relevant regulatory guidance, the institution classified as "Loss," the portion

of the recorded investment deemed to be the confirmed loss and classified the remaining recorded investment as "Substandard." For this loan, the amount classified "Loss" was less than the impairment amount (as determined under FAS 114). The institution charged off the "Loss" portion of the loan. After the charge-off, the portion of the ALLL related to this "Substandard" loan (1) reflects an appropriate measure of impairment under FAS 114, and (2) is included in the aggregate FAS 114 ALLL for all loans that were identified for evaluation and individually considered impaired. The aggregate FAS 114 ALLL is included in the institution's overall ALLL.

Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are not included in the scope of FAS 114.<sup>27</sup> Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer installment loans. FAS 5 addresses the accounting for impairment of these loans. Also, FAS 5 provides the accounting guidance for impairment of loans that are not identified for evaluation on an individual basis and loans that are individually evaluated but are not individually considered impaired. Institutions should ensure that they do not layer their loan-loss allowances. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss. Layering can happen when an institution includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional ALLL amount.<sup>28</sup>

While different institutions may use different methods, there are certain common elements that should be included in any loan-loss allowance methodology. Generally, an institution's methodology should—

- include a detailed analysis of the loan portfolio, performed on a regular basis;
- consider all loans (whether on an individual or group basis);
- identify loans to be evaluated for impairment on an individual basis under FAS 114 and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under FAS 5;
- consider all known relevant internal and external factors that may affect loan collectibility;
- be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
- consider the particular risks inherent in different kinds of lending;
- consider current collateral values (less costs to sell), where applicable;
- require that analyses, estimates, reviews, and other ALLL methodology functions be performed by competent and well-trained personnel;
- be based on current and reliable data;

27. In addition, FAS 114 does not apply to loans measured at fair value or at the lower of cost or fair value, leases, or debt securities.

28. According to the Federal Financial Institutions Examination Council's *Federal Register* notice, Implementation Issues Arising from FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995, institution-specific issues should be reviewed when estimating loan losses under FAS 114. This analysis should be

conducted as part of the evaluation of each individual loan reviewed under FAS 114 to avoid potential ALLL layering.

- be well documented, in writing, with clear explanations of the supporting analyses and rationale; and
- include a systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with GAAP.<sup>29</sup>

A systematic methodology that is properly

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29. Refer to paragraph 7.05 of the AICPA Audit Guide.

designed and implemented should result in an institution's best estimate of the ALLL. Accordingly, institutions should adjust their ALLL balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted ALLL balance in the general ledger.<sup>30</sup>

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30. Institutions should refer to the guidance on materiality in SEC Staff Accounting Bulletin No. 99, *Materiality*.

# ALLL Methodologies and Documentation

## Examination Objectives

Effective date November 2002

## Section 2072.2

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1. To evaluate internal controls over the loan-loss estimation process by evaluating the ALLL written policy and the process used to create and maintain the policy, loan-grading systems, and other associated internal controls over credit risk.
2. To determine the existence of an ALLL balance and review the summary schedule supporting it.
3. To analyze and review the evaluation for Statement of Financial Accounting Standards No. 114 (FAS 114) (for individually listed loans).
4. To analyze and review the evaluation for Statement of Financial Accounting Standards No. 5 (FAS 5) (for groups of loans).
5. To determine if the bank has adequately developed a range of loss and a margin for imprecision.
6. To determine that the ALLL reflects estimated credit losses for specifically identified loans (or groups of loans) and any estimated *probable* credit losses inherent in the remainder of the loan portfolio at the balance-sheet date.
7. To analyze and review the ALLL-documentation support.
8. To determine the adequacy of the bank's process to evaluate the ALLL methodology and to adjust the methodology, as needed.

# ALLL Methodologies and Documentation Examination Procedures

Effective date April 2011

## Section 2072.3

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1. Determine if the board of directors has developed and maintained an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provision for loan losses, or if it has instructed management to do so. Determine if the ALLL policies specifically address the bank's goals, risk profile, personnel, and other resources.
2. Determine if the board of directors has approved the written ALLL policy.
3. Determine if the bank's loan-loss estimate, in accordance with its methodology, is consistent with generally accepted accounting principles and supervisory guidance. Additionally, ensure that the bank's loan-loss estimate is materially consistent with the reported balance of the bank's ALLL account.
4. Determine if the ALLL methodology is periodically validated by an independent party in conformance with SR-11-7, and, if appropriate, revised.
5. Ascertain whether the audit committee is overseeing and monitoring the internal controls over the ALLL-documentation process.
6. Ascertain that the bank maintains adequate written documentation of its ALLL, including clear explanations of the supporting analyses and rationale. The documentation should consist of—
  - policies and procedures over the systems and controls that maintain an appropriate ALLL and over the ALLL methodology,
  - the loan-grading system or process,
  - a summary or consolidation (including losses) of the ALLL balance,
  - a validation of the ALLL methodology, and
  - periodic adjustments to the ALLL process.
7. Determine if the amount reported for the ALLL for each period and the provisions for loan and leases losses are reviewed and approved by the board of directors.

# ALLL Estimation Practices for Loans Secured by Junior Liens

## Section 2073.1

Effective date April 2012

The federal banking agencies<sup>1</sup> issued, in January 2012, “Interagency Supervisory Guidance on Allowance for Loan and Lease Losses Estimation Practices for Loans and Lines of Credit Secured by Junior Liens on 1–4 Family Residential Properties.” The guidance was issued to address the allowance for loan and lease losses (ALLL) estimation practices for junior-lien loans and lines of credit (collectively, junior liens). (See SR-12-3.)

Domestic banking organizations that are supervised by the Federal Reserve are reminded to consider all credit quality indicators relevant to their junior liens. Generally, this information should include the delinquency status of senior liens associated with the institution’s junior liens and whether the senior lien has been modified. Institutions should ensure that during the ALLL estimation process, sufficient information is gathered to adequately assess the probable loss incurred within junior-lien portfolios.

Based on the rapid growth in home equity lending during the 2003–2007 timeframe, a significant volume of home equity lines of credit (HELOCs) will be approaching the end of their draw periods within the next several years and will either convert to amortized loans or will start having principal due as a balloon payment. An institution with a significant number of HELOCs should ensure that its ALLL methodology appropriately captures the elevated borrower default risk associated with any upcoming payment shocks.

This 2012 ALLL guidance applies to institutions of all sizes. The guidance states that an institution should use reasonably available tools to determine the payment status of senior liens associated with its junior liens, such as credit reports, third-party services, or, in certain cases, a proxy. It is expected that large, complex institutions would find most tools reasonably available and would use proxies in limited circumstances.

The guidance does not add or modify existing regulatory reporting requirements issued by the agencies or current generally accepted accounting principles (GAAP). This guidance

reiterates key concepts included in GAAP and existing supervisory guidance related to the ALLL. (See, for example, SR-01-17 and SR-06-17 and their attachments. See also sections 2070.1 and 2072.1.)

Institutions also are reminded to follow appropriate risk-management principles in managing junior-lien loans and lines of credit, including the May 2005 “Interagency Credit Risk Management Guidance for Home Equity Lending.” (See SR-05-11 and section 2090.1.)

### ALLL ESTIMATION PRACTICES FOR LOANS AND LINES OF CREDIT SECURED BY JUNIOR LIENS ON 1–4 FAMILY RESIDENTIAL PROPERTIES

Amidst continued uncertainty in the economy and the housing market, federally regulated financial institutions are reminded to monitor all credit quality indicators relevant to credit portfolios, including junior liens. While the following guidance specifically addresses junior liens, it contains principles that apply to estimating the ALLL for all types of loans. Institutions also are reminded to follow appropriate risk-management principles in managing junior-lien loans and lines of credit, including those in the May 2005 “Interagency Credit Risk Management Guidance for Home Equity Lending.”

The December 2006 “Interagency Policy Statement on the Allowance for Loan and Lease Losses” (IPS) states: “Estimates of credit losses should reflect consideration of the significant factors that affect the collectibility of the portfolio as of the evaluation date.”

The “Interagency Credit Risk Management Guidance for Home Equity Lending” states: “Financial institutions should establish an appropriate ALLL and hold capital commensurate with the riskiness of portfolios. In determining the ALLL adequacy, an institution should consider how the interest-only and draw features of HELOCs during the lines’ revolving period could affect the loss curves for the HELOC portfolio. Those institutions engaging in programmatic subprime home equity lending or institutions that have higher risk products are expected to recognize the elevated risk of the activity when assessing capital and ALLL adequacy.”

1. The federal banking agencies are the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the National Credit Union Administration (NCUA).

While the 2012 ALLL guidance specifically addresses junior liens, it contains principles that apply to estimating the ALLL for *all types* of loans.

## Responsibilities of Management

### *Consideration of All Significant Factors*

Institutions should ensure that during the ALLL estimation process sufficient information is gathered to adequately assess the probable loss incurred within junior-lien portfolios. Generally, this information should include the delinquency status of senior liens associated with the institution's junior liens and whether the senior lien loan has been modified. Institutions with significant holdings of junior liens should gather and analyze data on the associated senior-lien loans it owns or services. When an institution does not own or service the associated senior-lien loans, it should use reasonably available tools to determine the payment status of the senior-lien loans. Such tools include obtaining credit reports or data from third-party services to assist in matching an institution's junior liens with its associated senior liens. Additionally, an institution may, as a proxy, use the relevant performance data on similar senior liens it owns or services. An institution with an insignificant volume of junior-lien loans and lines of credit may use judgment when determining what information about associated senior liens not owned or serviced is reasonably available.

Institutions with significant holdings of junior liens should also periodically refresh other credit quality indicators the organization has deemed relevant about the collectibility of its junior liens, such as borrower credit scores and combined loan-to-value ratios (CLTVs), which include both the senior and junior liens. An institution should refresh relevant credit quality indicators as often as necessary considering economic and housing market conditions that affect the institution's junior-lien portfolio. As noted in SR-06-17, "changes in the level of the ALLL should be directionally consistent with changes in the factors, taken as a whole, that evidence credit losses." For example, if declining credit quality trends in the factors relevant to either junior liens or their associated senior-lien loans are evident, the ALLL level as a percentage of the junior-lien portfolio should generally

increase, barring unusual charge-off activity. Similarly, if improving credit quality trends are evident, the ALLL level as a percentage of the junior-lien portfolio should generally decrease.

Institutions routinely gather information for credit-risk management purposes, but some may not fully use that information in the allowance estimation process. Institutions should consider all reasonably available and relevant information in the allowance estimation process, including information obtained for credit-risk management purposes. Financial Accounting Standards Board Accounting Standards Codification (ASC) Topic 450 states that losses should be accrued by a charge to income if information available prior to issuance of the financial statements indicates that it is probable that an asset has been impaired. The 2006 IPS states, "...estimates of credit losses should reflect consideration of all significant factors." (See SR-06-17 and its attachment.) Consequently, it is considered inconsistent with both GAAP and supervisory guidance to fail to gather and consider reasonably available and relevant information that would significantly affect management's judgment about the collectibility of the portfolio.<sup>2</sup>

### *Adequate Segmentation*

Institutions normally segment their loan portfolio into groups of loans based on risk characteristics as part of the ALLL estimation process. Institutions with significant holdings of junior liens should ensure adequate segmentation within their junior-lien portfolio to appropriately estimate the allowance for high-risk segments within this portfolio. A lack of segmentation can result in an allowance established for the entire junior-lien portfolio that is lower than what the allowance would be if high-risk loans were segregated and grouped together for evaluation in one or more separate segments. The following credit quality indicators may be appropriate for use in identifying high-risk junior-lien portfolio segments:

2. "Portfolio" refers to loans collectively evaluated for impairment under ASC Topic 450; this supervisory guidance may also be applicable to junior-lien loans that are subject to measurement for impairment under ASC Subtopic 310-10, Receivables - Overall (formerly Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*) and ASC Subtopic 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality (formerly AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*).



- delinquency and modification status of an institution's junior liens
- delinquency and modification status of senior-lien loans associated with an institution's junior liens
- current borrower credit score
- current CLTV
- origination channel
- documentation type
- property type (for example, investor owned or owner-occupied)
- geographic location of property
- origination vintage
- HELOCs where the borrower is making only the minimum payment due
- HELOCs where current information and conditions indicate that the borrower will be subject to payment shock

In particular, institutions should ensure their ALLL methodology adequately incorporates the elevated borrower default risk associated with payment shocks due to (1) rising interest rates for adjustable rate junior liens, including HELOCs,<sup>3</sup> or (2) HELOCs converting from interest-only to amortizing loans. If the default rate of junior liens that have experienced payment shock is higher than the default rate of junior liens that have not experienced payment shock, an institution should determine whether it has a significant number of junior liens approaching their conversion to amortizing loans or approaching an interest rate adjustment date. If so, to ensure the institution's estimate of credit losses is not understated, it would be necessary to adjust historical default rates on these junior liens to incorporate the effect of payment shocks that, based on current information and conditions, are likely to occur.

Adequate segmentation of the junior-lien portfolio by risk factors should facilitate an institution's ability to track default rates and loss severity for high-risk segments and its ability to appropriately incorporate these data into the allowance estimation process.

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3. Forecasts of future interest rate increases should not be included in the determination of the ALLL. However, if rates have risen since the last rate adjustment, the effect of the increase on the amount of the payment at the next rate adjustment should be considered.

### *Qualitative or Environmental Factor Adjustments*

As noted in SR-06-17, institutions should adjust a loan group's historical loss rate for the effect of qualitative or environmental factors that are likely to cause estimated credit losses as of the evaluation date to differ from the group's historical loss experience. Institutions typically reflect the overall effect of these factors on a loan group as an adjustment that, as appropriate, increases or decreases the historical loss rate applied to the loan group. Alternatively, the effect of these factors may be reflected through separate standalone adjustments within the ASC Subtopic 450-20 component of the ALLL.

When an institution uses qualitative or environmental factors to estimate probable losses related to individual high-risk segments within the junior-lien portfolio, any adjustment to the historical loss rate or any separate standalone adjustment should be supported by an analysis that relates the adjustment to the characteristics of and trends in the individual risk segments. In addition, changes in the allowance allocation for junior liens should be directionally consistent with changes in the factors taken as a whole that evidence credit losses on junior liens, keeping in mind the characteristics of the institution's junior-lien portfolio.

### *Charge-Off and Nonaccrual Policies*

Banking institutions should ensure that their charge-off policy on junior liens is in accordance with the June 2000 Uniform Retail Credit Classification and Account Management Policy. (See SR-00-8 and the appendix of section 2130.1.) As stated in SR-06-17, "when available information confirms that specific loans, or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL."

Institutions also should ensure that income-recognition practices related to junior liens are appropriate. Consistent with GAAP and regulatory guidance, institutions are expected to have revenue recognition practices that do not result in overstating income. Placing a junior lien on nonaccrual, including a current junior lien, when payment of principal or interest in full is not expected is one appropriate method to ensure that income is not overstated. An institution's income-recognition policy should incorporate

management's consideration of all reasonably available information including, for junior liens, the performance of the associated senior liens as well as trends in other credit quality indicators. The policy should require that consideration of these factors takes place before foreclosure on the senior lien or delinquency of the junior lien. The policy should also explain how management's consideration of these factors affects income recognition prior to foreclosure on the senior lien or delinquency of the junior lien to ensure income is not overstated.

### *Responsibilities of Examiners*

To the extent an institution has significant holdings of junior liens, examiners should assess the appropriateness of the institution's ALLL methodology and documentation related to these loans, and the appropriateness of the level of the ALLL established for this portfolio. As noted in SR-06-17, for analytical purposes, an institution should attribute portions of the ALLL to loans that it individually evaluates and determines to be impaired under ASC Subtopic 310-10 and to groups of loans that it evaluates collectively under ASC Subtopic 450-20. However, the ALLL is available to cover all charge-offs that arise from the loan portfolio.

Consistent with SR-06-17, in their review of the junior-lien portfolio, examiners should consider all significant factors that affect the collectibility of the portfolio. Examiners should take the following steps when reviewing the appropriateness of an institution's allowance that is established for junior liens:

- Evaluate the institution's ALLL policies and

procedures and assess the methodology that management uses to arrive at an overall estimate of the ALLL for junior liens. This should include whether all significant qualitative or environmental factors that affect the collectibility of the portfolio (including those factors previously discussed) have been appropriately considered in accordance with GAAP.

- Review management's use of loss estimation models or other loss estimation tools to ensure that the resulting estimated credit losses are in conformity with GAAP.
- Review management's support for any qualitative or environmental factor adjustments to the allowance related to junior liens. Examiners should ensure that all relevant qualitative or environmental factors were considered and adjustments to historical loss rates for specific risk segments within the junior-lien portfolio are supported by an analysis that relates the adjustment to the characteristics of and trends in the individual risk segments.
- Review the interest income accounts associated with junior liens to ensure that the institution's net income is not overstated.

If the examiner concludes that the reported ALLL for junior liens is not appropriate or determines that the ALLL evaluation process is deficient, recommendations for correcting these deficiencies, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination. Examiners should cite any departures from GAAP and regulatory guidance, as applicable. Additional supervisory action may also be taken based on the magnitude of the observed shortcomings in the ALLL process.

# ALLL Estimation Practices for Loans Secured by Junior Liens Examination Objectives

Effective date April 2012

Section 2073.2

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The examination objectives for an institution that has significant holdings of loans secured by junior liens are as follows:

1. To evaluate the appropriateness of the institution's methodology and documentation of the allowance for loan and lease losses (ALLL) related to these loans.
2. To ascertain whether the institution's policies, practices, procedures, and internal controls regarding the ALLL estimation practices for loans secured by junior liens are sufficient.
3. To determine whether the level of the ALLL

is reasonable and adequate for the institution's volume of such loans outstanding.

4. To evaluate if the institution has fully considered and accounted for all significant qualitative or environmental factors that affect the collectability of such loans.
5. To ascertain whether the portfolio has been properly accounted in accordance with generally accepted accounting principles and whether all applicable supervisory and regulatory guidance, as well as statutory and regulatory requirements, have been adhered to.

# ALLL Estimation Practices for Loans Secured by Junior Liens Examination Procedures

Effective date April 2012

## Section 2073.3

1. To the extent an institution has significant holdings of loans secured by junior liens, assess the appropriateness of the institution's
  - a. allowance for loan and lease loss (ALLL) methodology and documentation related to these loans, and
  - b. ALLL level established for this portfolio.
2. During the examination's review of the of the junior-lien portfolio, consider all significant qualitative or environmental factors that affect the collectibility of the junior-lien portfolio and whether they have been appropriately considered in accordance with generally accepted accounting principles (GAAP).
3. Perform the following steps when reviewing the appropriateness of the institution's ALLL that is established for junior liens:
  - a. Evaluate the institution's ALLL policies and procedures and assess the methodology that management uses to arrive at an overall estimate of the ALLL for junior liens.
  - b. Review management's use of loss-estimation models or other loss-estimation tools to ensure that the resulting estimated credit losses are in conformity with GAAP.
- c. Review management's support for any qualitative or environmental factor adjustments to the ALLL related to junior liens. Ensure that all relevant qualitative or environmental factors were considered and adjustments to historical loss rates for specific risk segments within the junior-lien portfolio are supported by an analysis that relates the adjustment to the characteristics of and trends in the individual risk segments.
- d. Review the interest income accounts associated with junior liens to ensure that the institution's net income is not overstated.
4. Provide comments in the examination report when the ALLL for junior liens is not appropriate or if the ALLL evaluation process is deficient. Include recommendations for correcting these deficiencies and any concerns regarding an appropriate level for the ALLL.
5. Cite in the examination report any departures from GAAP and regulatory guidance, as applicable.

### INTRODUCTION

The term “commercial and industrial loan” is commonly used to designate loans to a corporation, commercial enterprise, or joint venture that are not ordinarily maintained in either the real estate or consumer installment loan portfolios. Generally, commercial loans are the largest asset concentration of a state member bank, offer the most complexity, and require the greatest commitment from bank management to monitor and control risks. Proper management of these assets requires a clearly articulated credit-policy that imposes discipline and sound loan administration. Since lenders are subject to pressures related to productivity and competition, they may be tempted to relax prudent credit-underwriting standards to remain competitive in the marketplace, thus increasing the potential for risk. Examiners need to understand the unique characteristics of the varying types of commercial and industrial loans, as well as how to properly analyze their quality.

Commercial loans are extended on a secured or unsecured basis with a wide range of purposes, terms, and maturities. While the types of commercial and industrial loans can vary widely depending on the purpose of loans made and market characteristics where the bank operates, most commercial and industrial loans will primarily be made in the form of a seasonal or working-capital loan, term business loan, or loan to an individual for a business purpose. This section will provide examiners with a fundamental understanding of secured and unsecured transactions, loan evaluation and coverage techniques, the key principles for assessing credit quality, minimum documentation standards for loan line sheets, and basic bankruptcy law, as well as an overview of sections 23A and 23B of the Federal Reserve Act and tie-in arrangements. Other sections of this manual discuss more specific types of lending.

### PRIMARY TYPES OF COMMERCIAL AND INDUSTRIAL LOANS

#### Seasonal or Working-Capital Loans

Seasonal or working-capital loans provide a business with short-term financing for inven-

tory, receivables, the purchase of supplies, or other operating needs during the business cycle. These types of loans are often appropriate for businesses that experience seasonal or short-term peaks in current assets and current liabilities, such as a retailer who relies heavily on a holiday season for sales or a manufacturing company that specializes in summer clothing. These types of loans are often structured in the form of an advised line of credit or a revolving credit. An advised revocable line of credit is a revocable commitment by the bank to lend funds up to a specified period of time, usually one year. Lines of credit are generally reviewed annually by the bank, do not have a fixed repayment schedule, and may not require fees or compensating balances. In the case of unadvised lines of credit, the bank has more control over advances and may terminate the facility at any time, depending on state law or legal precedents. A revolving credit is valid for a stated period of time and does not have a fixed repayment schedule, but usually it has a required fee. The lender has less control over a revolving credit since there is an embedded guarantee to make advances within the prescribed limits of the loan agreement. The borrower may receive periodic advances under the line of credit or the revolving credit. Repayment of the loans is generally accomplished through conversion or turnover of short-term assets. Interest payments on seasonal loans are usually paid throughout the term of the loan, such as monthly or quarterly.

Seasonal or working-capital loans are intended to be repaid through the cash flow derived from converting the financed assets to cash. The structure of the loans can vary, but they should be closely tied to the timing of the conversion of the financed assets. In most cases, seasonal or working-capital facilities are renewable at maturity, are for a one-year term, and include a clean-up requirement for a period sometime during the low point or contraction phase of the business cycle. The clean-up period is a specified period (usually 30 days) during the term of the loan in which the borrower is required to pay off the loan. While this requirement is becoming less common, it provides the bank with proof that the borrower is not dependent on the lender for permanent financing. It is important to note, however, that an expanding business may not be able to clean up its facility since it may be increasing its current assets.

### *Analysis of Seasonal and Working-Capital Loans*

The analysis of a seasonal loan is best accomplished by a monthly or quarterly review of a company's balance sheet and income statements to identify the peak and contraction phases of the business cycle. The lender should know when the peak and contraction phases are, and the loan should be structured accordingly. The lender's primary objective is to determine whether the advances are being used for the intended purposes (inventories or payables) and not for the acquisition of fixed assets or payments on other debts. Repayments on the facility should also be consistent with the conversion of assets. If the borrower has other loan facilities at the bank, all credit facilities should be reviewed at the same time to ensure that the activity with the seasonal or working-capital facility is not linked to other loans in the bank. Projections of sources and uses of funds are also a valuable tool for reviewing a seasonal or working-capital line of credit and determining the sales cycle.

Quarterly balance-sheet and income statements are very helpful when a comparison is made with the original projections. Other helpful information can be obtained from a review of an aging of accounts receivable for delinquencies and concentrations, a current list of inventory, an accounts-payable aging, and accruals made during the quarter. This information can be compared with the outstanding balance of the facility to ensure that the loan is not overextended and that the collateral margins are consistent with borrowing-base parameters. A borrowing base is the amount the lender is willing to advance against a dollar value of pledged collateral; for example, a bank will only lend up to a predetermined specified percentage of total outstanding receivables less all past-due accounts more than a certain number of days delinquent. A borrowing-base certificate should be compiled at least monthly or more often during peak activity in the facility. When reviewing seasonal loans, examiners should remember that a bank relies heavily on inventory as collateral in the beginning of a company's business cycle and on receivables toward the end of the business cycle. However, in traditional working-capital loans, greater emphasis is usually placed on accounts receivable as collateral throughout the loan's tenure.

Normally, a bank is secured by a perfected blanket security interest on accounts receivable, inventory, and equipment and on the proceeds from the turnover of these assets. Well-capitalized companies with a good history of seasonal payout or cleanup may be exceptions. An annual lien search, however, would be prudent under this type of lending relationship to detect any purchase-money security interest that may have occurred during the business cycle.

The following are potential problems associated with working-capital and seasonal loans:

- *Working-capital advances used for funding losses.* A business uses advances from a revolving line of credit to fund business losses, including the funding of wages, business expenses, debt service, or any other cost not specifically associated with the intended purpose of the facility.
- *Working-capital advances funding long-term assets.* A business will use working-capital funds to purchase capital assets that are normally associated with term business loans.
- *Trade creditors not paid out at end of business cycle.* While the bank may be paid out, some trade creditors may not get full repayment. This can cause a strained relationship as unpaid trade creditors may be less willing to provide financing or offer favorable credit terms in the future. In turn, the business will become more reliant on the bank to support funding needs that were previously financed by trade creditors.
- *Overextension of collateral.* The business does not have the collateral to support the extension of credit, causing an out-of-borrowing-base situation. Examiners should review borrowing-base certificates to verify that coverage meets the prescribed limitations established by the bank's credit policy for the specific asset being financed.
- *Value of inventory declines.* If a business does not pay back the bank after inventory is converted to cash or accounts receivable, the value of the inventory declines. Other causes of inventory devaluation include obsolescence; a general economic downturn; or, in the case of a commodity, market volatility. Declines in inventory value will commonly put a working-capital facility in an out-of-borrowing-base situation and require the excess debt to be amortized and repaid through future profits of the business.

- *Collectibility of accounts receivable declines.* The increasingly past-due status of accounts receivable or deteriorating credit quality of account customers both result in the noncollection of receivables. This can also cause an out-of-borrowing-base situation for the lending institution.
- *Working-capital advances used to fund long-term capital.* Funds may be inappropriately used to repurchase company stock, pay off subordinated debt holders, or even pay dividends on capital stock.

These situations may cause a loan balance to be remaining at the end of the business cycle. If this should occur, the bank generally has one of three options: (1) Require the unpaid balance to be amortized. This option is, however, dependent on the ability of the business to repay the debt through future profits. (2) Request the borrower to find another lender or require an infusion of capital by the borrower. This is not always a feasible option because of the probable weakened financial condition of the business and ownership under these circumstances. (3) Liquidate the collateral. Foreclosing on the collateral should only be executed when it becomes obvious that the business can no longer function as a going concern. The problem with this option is that once the bank discovers that the business is no longer a viable concern, realizing the full value of the collateral is in jeopardy. The need to resort to any of these options may prompt criticism of the credit.

## Term Business Loans

Term business loans are generally granted at a fixed or variable rate of interest, have a maturity in excess of one year, and are intended to provide an organization with the funds needed to acquire long-term assets, such as physical plants and equipment, or finance the residual balance on lines of credit or long-term working capital. Term loans are repaid through the business's cash flow, according to a fixed-amortization schedule, which can vary based on the cash-flow expectations of the underlying asset financed or the anticipated profitability or cash flow of the business. Term business loans involve greater risk than short-term advances because of the length of time the credit is extended. As a result of this greater risk, term

loans are often secured. Loan interest may be payable monthly, quarterly, semiannually, or annually.

In most cases, the terms of these loans are detailed in formal loan agreements with affirmative and negative covenants that place certain conditions on the borrower throughout the term of the loan. Generally, loan agreements substantially enhance a borrower/banker relationship because they encourage and promote more frequent communication between the parties. In affirmative covenants, the borrower pledges to fulfill certain requirements, such as maintain adequate insurance coverage, make timely loan repayments, or ensure the financial stability of the business. Negative or restrictive covenants prohibit or require the borrower to refrain from certain practices, such as selling or transferring assets, defaulting, falling below a minimum debt coverage ratio, exceeding a maximum debt-to-equity ratio, or taking any action that may diminish the value of collateral or impair the collectibility of the loan. Covenants should not be written so restrictively that the borrower is constantly in default over trivial issues; however, violations should be dealt with immediately to give credibility to the agreement. Violations of these covenants can often result in acceleration of the debt maturity. A formal loan agreement is most often associated with longer-term loans. If a formal agreement does not exist, the term loans should be written with shorter maturities and balloon payments to allow more frequent review by bank management.

## *Analysis of Term Business Loans*

While a seasonal or working-capital loan analysis emphasizes the balance sheet, the analysis of term loans will focus on both the balance sheet and the income statement. Because a term loan is repaid from excess cash flow, the long-term viability of the business is critical in determining the overall quality of the credit. In evaluating long-term earnings, the examiner must develop a fundamental understanding of the company's industry and competitive position in the marketplace. Most of the analysis will be conducted based on the historical performance of the business and its history of making payments on its debt. Any historical record of inconsistencies or inability to perform on existing debt should prompt an in-depth review to determine the ability of the borrower to meet the

loan's contractual agreements. One of the most critical determinations that should be made when evaluating term debt is whether the term of the debt exceeds the useful life of the underlying asset being financed.

While cash flow of the business is the primary source of repayment for a term loan, a secondary source would be the sale of the underlying collateral. Often, if circumstances warrant a collateral sale, the bank may face steep discounts and significant expenses related to the sale. Examiners should carefully consider these issues when evaluating the underlying value of collateral under a liquidation scenario.

The following are potential problems associated with term business loans:

- The term of the loan is not consistent with the useful life of collateral.
- Cash flow from operations does not allow for adequate debt amortization, a fundamental problem that can only be solved by improved performance.
- The gross margin of the business is narrowing, which requires the business to sell more product to produce the same gross profit. Higher sales volume could require more cash for expansion of current assets, leaving less cash for debt amortization. This situation is a common by-product of increased competition.
- Sales are lower than expected. In the face of lower sales, management is unable or unwilling to cut overhead expenses, straining cash flow and resulting in diminished debt-servicing ability.
- Fixed assets that are financed by term loans become obsolete before the loans are retired, likely causing the value of underlying collateral to deteriorate.
- The business's excess cash is spent on higher salaries or other unnecessary expenses.
- The payments on term debt have put a strain on cash flow, and the business is unable to adequately operate or allow natural expansion.
- The balance sheet of the business is weakening. The overall financial condition of the business is deteriorating because of poor performance or unforeseen occurrences in the industry.

## Shared National Credits

The Federal Reserve System participates in a program for the uniform review of shared

national credits (SNCs). An SNC is defined as any loan or commitment in an original amount of \$20 million or more that is (1) shared at its inception by two or more supervised institutions under a formal loan agreement and (2) sold in part to one or more supervised institutions with the purchasing bank assuming its pro rata share of the credit risk. Loans sold to affiliate banks of the same holding company are not part of the SNC program. If the outstanding balance or commitment of an SNC credit falls below \$20 million after its inception, and it is not criticized, the credit will not be reviewed at the next review date. Therefore, the examiner should conduct an individual review of the credit at the bank under examination. However, if the former SNC facility fell below the threshold through a charge-off, and was classified or specially mentioned at the most recent SNC review, the credit relationship would continue to be reviewed under the SNC program until such time that the balance falls below \$10 million. The Federal Deposit Insurance Corporation (FDIC), the state agencies, and the Office of the Comptroller of the Currency (OCC) also participate in this program. The Federal Reserve carries out the examination of SNCs at the lead or agent banks that are state member banks, state-chartered foreign branches, and credit-extending nonbank subsidiaries of domestic and foreign organizations. The FDIC is primarily responsible for any SNC credits at state nonmember banks, and the OCC supervises the review of those SNCs in which the lead bank is a national bank or an OCC-chartered foreign branch.

SNCs should not be analyzed or reviewed during the examination of the individual participating bank. If the examiner is uncertain whether the credit was reviewed under the SNC program, the respective Reserve Bank coordinator should be contacted. If credits eligible for the program are found but have not been reviewed (other than new SNCs since the time of the last SNC program review), the examiner should submit a memorandum detailing those credits to the respective Reserve Bank coordinator to be forwarded to the SNC coordinator at the Federal Reserve Bank of New York.

## SECURED AND UNSECURED TRANSACTIONS

This subsection is intended to be a general reference for an examiner's review of a credit



file to determine whether the bank's collateral position is properly documented. Examiners should be aware that secured transactions encompass an extensive body of law that is rather technical in nature. The following discussion contains general information for examiners on the basic laws that govern a bank's security interest in property and on the documentation that needs to be in a loan file to properly document a perfected security interest in a borrower's assets.

## Secured Transactions

Most secured transactions in personal property and fixtures are governed by article 9 of the Uniform Commercial Code (UCC). The UCC has been adopted by all 50 states, the District of Columbia, and the Virgin Islands. Timing differences as well as filing locations differ from state to state. Failure to file a financing statement in a timely manner or in the proper location will compromise a lender's security interest in the collateral.

Article 9 of the UCC applies to any transaction that is intended to create a security interest in personal property. Mortgage transactions are not covered, marine mortgages are filed with the Coast Guard, and aircraft liens are filed with the Federal Aviation Administration. A "security interest" is defined in the UCC as "an interest in personal property or fixtures which secures payment or performance of an obligation." A secured transaction requires that there be an *agreement* between the parties indicating the parties' intention to create a security interest for the benefit of the creditor or secured party. This agreement is commonly referred to as a security agreement.

Article 9 of the UCC refers to two different concepts related to security interests: attachment and perfection. Attachment is the point in time at which the security interest is created and becomes enforceable against the debtor. Perfection refers to the steps that must be taken in order for the security interest to be enforceable against third parties who have claims against collateral.

### *Attachment of Security Interest*

The three requirements for the creation of a security interest are stated in UCC section

9-203(1). Once the following requirements are met, the security interest attaches:

- The collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement that contains a description of the collateral and, when the security interest covers crops now growing or to be grown or timber to be cut, a description of the land concerned.
- Value has been given to the debtor.
- The debtor has rights in the collateral.

Thus, unless the collateral is in the possession of the secured party, there must be a written security agreement that describes the collateral. The description does not have to be very specific or detailed—"any description of personal property . . . is sufficient whether or not it is specific if it reasonably identifies what is described" (see section 9-110). The agreement must also be signed by the debtor. The creditor may sign it, but its failure to do so does not affect the agreement's enforceability against the debtor.

"Giving value" is any consideration that supports a contract. Value can be given by a direct loan, a commitment to grant a loan in the future, the release of an existing security interest, or the sale of goods on contract.

While the debtor must have "rights" in the collateral, he or she does not necessarily have to have title to the property. For example, the debtor may be the beneficiary of a trust (the trustee has title of trust assets) or may lease the collateral. The debtor, in such cases, has rights in the collateral, but does not hold the title to the collateral. The secured party, however, only obtains the debtor's limited interest in the collateral on default if the debtor does not have full title to the collateral.

### *Perfection of Security Interest in Property*

Perfection represents the legal process by which a bank secures an interest in property. Perfection provides the bank assurance that it has an interest in the collateral. The category of collateral will dictate the method of perfection to be used. The most common methods of perfection are (1) automatic perfection when the security interest attaches (such as in the case of purchase-money security interests applicable to consumer goods other than vehicles); (2) perfection by possession; (3) the filing of a financing state-

ment in one or more public filing offices (The financing statement is good for five years, and the lender must file for a continuation within the six-month period before expiration of the original statement.) and (4) compliance with a state certificate of title law or central filing under a state statute other than the UCC, such as registration of vehicles.

The most common method of perfecting a security interest is public filing. Public filing serves as a constructive notice to the rest of the world that the bank claims a security interest in certain property of the debtor described in both the security agreement and the financing statement. Public filing is accomplished by filing a financing statement (UCC-1) in a public office, usually the county recorder or secretary of state. The system of filing required by the UCC provides for a notice filing whereby potential creditors can determine the existence of any outstanding liens against the debtor's property.

The form of the financing statement and where to file it varies from state to state. While the filing of a nonstandard form will generally be accepted, the failure to file in the proper public office can jeopardize the priority of the lender's security interest. The UCC provides three alternative filing systems:

- *Alternative System One.* Liens on minerals, timber to be cut, and fixtures are filed in the county land records. All other liens are filed in the office of the secretary of state.
- *Alternative System Two.* The majority of states have adopted this version. It is the same as system one, except liens on consumer goods, farm equipment, and farm products are filed in the county where the debtor resides or in the county where the collateral is located if it is owned by a nonresident.
- *Alternative System Three.* In a minority of states, filings made with the secretary of state must also be filed in the county of the borrower's business (or residence if there is no place of business in that state). Otherwise, the requirement in these states is the same as system two.

As each state may select any of the above three alternatives or a modified version of them, it is important that the examiner ascertain the filing requirements of the state(s) where the bank's customer operates. Most importantly, it is the location of the borrower, not the bank, that

determines where the financing statement must be filed.

### *Evaluation of Security Interest in Property*

Key items to look for in evaluating a security interest in property include the following:

- *Security agreement.* There should be a proper security agreement, signed and dated by the borrower, that identifies the appropriate collateral to be secured. It should include a description of the collateral and its location in sufficient detail so the lender can identify it, and should assign to the lender the right to sell or dispose of the collateral if the borrower is unable to pay the obligation.
- *Collateral possession.* If the institution has taken possession of the collateral to perfect its security interest, management of the institution should have an adequate record-keeping system and proper dual control over the property.
- *Financing statement.* If the institution has filed a financing statement with the state or local authority to perfect its security interest in the collateral, in general, it should contain the following information:
  - names of the secured party and debtor
  - the debtor's signature
  - the debtor's mailing address
  - the address of the secured party from which information about the security interest may be obtained
  - the types of the collateral and description of the collateral (Substantial compliance with the requirements of UCC section 9-402 is sufficient if errors are only minor and not seriously misleading. Some states require the debtor's tax ID number on the financing statement.)
- *Amendments.* Not all amendments require the borrower's signature, and banks may file an amendment for the following reasons:
  - borrower's change of address
  - creditor's change of address
  - borrower's name change
  - creditor's name change
  - correction of an inaccurate collateral description
  - addition of a trade name for the borrower that was subsequently adopted

- *Where to file a financing statement.* In general, financing statements filed in good faith or financing statements not filed in all of the required places are effective with respect to any collateral covered by the financing statement against any person with knowledge of the statement's contents. If a local filing is required, the office of the recorder in the county of the debtor's residence is the place to file. If state filing is required, the office of the secretary of state is the place to file.
- *Duration of effectiveness of a financing statement.* Generally, effectiveness lapses five years after filing date. If a continuation statement is filed within six months before the lapse, effectiveness is extended five years after the last date on which the filing was effective. Succeeding continuation statements may be filed to further extend the period of effectiveness.

### *Perfection of Security Interest in Real Estate*

As previously mentioned, real estate is expressly excluded from coverage under the UCC. A separate body of state law covers such interests. However, for a real estate mortgage to be enforceable, the mortgage must be recorded in the county where the real estate covered by the mortgage is located.

*Real estate mortgage or deed of trust.* When obtaining a valid lien on real estate, only one document is used, the mortgage or deed of trust. The difference between a mortgage and a deed of trust varies from state to state; however, the primary difference relates to the process of foreclosure. A mortgage generally requires a judicial foreclosure, whereas, in some states, a foreclosure on a deed of trust may not. Nearly all matters affecting the title to the real estate, including the ownership thereof, are recorded in the recorder's office.

When determining the enforceability of a real estate mortgage or deed of trust, the examiner should be aware of the following requirements:

- The mortgage must be in writing.
- To be recordable, the mortgage must be acknowledged. There are different forms of acknowledgments for various situations depending on whether individuals, corporations, partnerships, or other entities are execut-

ing the mortgage. Make sure that the form of the acknowledgment used is in accordance with the type of individual or entity executing the mortgage.

- If a corporation is the mortgagor, its articles of incorporation or bylaws often will specifically state which officers have authority to sign an instrument affecting real estate. In these instances, the designated officer should be required to sign. If the corporation has a seal, that also must be affixed. If the corporation does not have a seal, this fact must be shown in the acknowledgment.
- As soon as possible after the mortgage is executed, it should be recorded in the office of the recorder for each county in which the property described in the mortgage is located. In most cases, the borrower signs an affidavit that indicates, in part, that he or she will not attempt to encumber the property while the lender is waiting for the mortgage to be recorded. In smaller community banks, common practice may be not to advance any of the money under the loan until the mortgage has been recorded and the later search completed. In larger banks or cities, however, this practice is often not practical.
- If the mortgagor is married, the spouse must join in the execution of the mortgage to subject his or her interest to the lien of the mortgage. If the mortgagor is single, the mortgage should indicate that no spouse exists who might have a dower interest or homestead interest in the property.
- If the mortgagor is a partnership, it must be determined whether the title is in the name of the partnership or in the names of the individual partners. If the title is in the names of the individual partners, their spouses should join in executing the mortgage. If the title is in the name of the partnership, those partners who are required to sign under the partnership agreement should sign.

### Unsecured Transactions

Unsecured transactions are granted based on the borrower's financial capacity, credit history, earnings potential, and liquidity. Assignment of the borrower's collateral is not required, and repayment is based on the terms and conditions of the loan agreement. While unsecured loans often represent the bank's strongest borrowers,

the unsecured loan portfolio can represent its most significant risk. One of the primary concerns related to unsecured credit is that if the borrower's financial condition deteriorates, the lender's options to work out of the lending relationship deteriorate as well. In general, if a credit is unsecured, the file should contain reliable and current financial information that is sufficient to indicate that the borrower has the capacity and can be reasonably expected to repay the debt.

### *Problem Loans*

The following are key signals of an emerging problem loan:

- *Outdated or inaccurate financial information on the borrower.* The borrower is unwilling to provide the financial institution with a current, complete, and accurate financial statement at least annually. Management should also be requesting a personal tax return (and all related schedules) on the borrower. While borrowers will usually present their personal financial statements in the most favorable light, their income tax return provides a more conservative picture.
- *The crisis borrower.* The borrower needed the money yesterday, so the bank advanced unsecured credit.
- *No specific terms for repayment.* The unsecured loan has no structure for repayment, and it is commonly renewed or extended at maturity.
- *Undefined source of repayment.* These types of loans are often repaid through excess cash flow of the borrower, sale of an asset(s), or loan proceeds from another financial institution. These repayment sources are often not identified and are unpredictable.

## LOAN-SAMPLING AND COVERAGE REQUIREMENTS

A thorough review of a bank's commercial loan portfolio is one of the most important elements of a bank examination. Credit reviews are an examiner's primary means for evaluating the effectiveness of internal loan-review and credit-grading systems, determining that credit is being extended in compliance with internal policies

and credit standards, and evaluating the adequacy of the allowance for loan and lease losses. Credit reviews also help the examiner to ascertain a bank's compliance with applicable laws and regulations, judge the safety and soundness of the bank's lending and credit-administration functions, and, most important, evaluate directly the quality of the bank's loan portfolio. Since examiners need to make the most efficient use of their time during their on-site review of the loan portfolio, it is not practical to review every loan in the bank's loan portfolio. Instead, examiners must select for review a sample of loans<sup>1</sup> that is sufficient in size and scope to enable them to reach reliable conclusions about the bank's overall lending function. At a minimum, examiners should include in their sample a group of loans referred to as the "core group,"<sup>2</sup> as described below.

SR-02-19 describes an alternative to the traditional statistical sampling procedures (see SR-94-13) found in this section. (See also section 2082.1.) The alternative statistical sampling procedures of SR-02-19 may only be used for reviewing loans at certain community banks—those rated CAMELS composite and asset quality 1 or 2 with assets of less than \$1 billion. The statistical sampling approach is not recommended for use at de novo banks and other banks with unusually high or low capital ratios. If the statistical sampling procedures of SR-02-19 are *not* used, the minimum loan-review coverage is still 40 percent of the core group of loans.

### Core Group

Commercial and industrial loans and commercial real estate loans subject to examiner review should include the following:

- All problem loans, including loans that have been previously classified or specially mentioned by the respective Reserve Bank or state banking department during the most recent

1. For the purposes of this section, the term "loans" includes all sources of credit exposure arising from loans and leases. This exposure includes guarantees, letters of credit, and other loan commitments.

2. If the examiner decides it is practical, the requirements and fundamental guidance set forth in this section can be applied to all types of commercial and industrial loans, as well as to commercial real estate loans or any other type of loan made by the bank.

examinations, loans that are past due as of the date of examination, loans that are on non-accrual status, loans that have been designated as impaired according to the guidelines set forth in Statement No. 114 of the Financial Accounting Standards Board, loans that are considered renegotiated or restructured debt, and loans that are included on the bank's most recent internal watch list.

- All large loans, defined as loans or aggregations of loans to the same or related borrowers that exceed a dollar cutoff level established by the examiner-in-charge. This cutoff will typically be equal to about 1 percent of a bank's

equity capital, but a higher or lower percentage may be warranted depending on the circumstances of the bank being examined.

- Insider loans, as defined by the Board's Regulation O (12 CFR 215).

This core group of loans (problem loans, special-mention loans, insider loans, and large loans) should represent a substantial portion of the dollar volume of a bank's total commercial and industrial loans and commercial real estate loans. Nevertheless, in the majority of cases, the examiner should select additional loans from the remaining portfolio to be reasonably assured of making an accurate and comprehensive assessment of the condition of the bank's overall loan portfolio and lending activities.<sup>3</sup>

In determining the size and nature of additional loans to be reviewed, the examiner should consider the coverage ratio of the core group of loans.<sup>4</sup> If the core group of loans reviewed constitutes a substantial portion of the total dollar volume of loans (at least 40 to 50 percent), then sufficient additional loans should be reviewed to raise the coverage ratio another 10 percent. If, on the other hand, the coverage ratio of the core group of loans reviewed is lower, primarily because the bank has fewer large loans, then a greater number and higher dollar volume of loans outside the core group should be reviewed. For example, if the coverage of the core group of loans amounts to only 20 to 30 percent, then the loans reviewed in the remaining portfolio should raise the coverage ratio to a minimum of 40 to 50 percent. Loan coverage at the lower end of this range (40 percent) would be appropriate only if the bank—

- is in satisfactory condition,
- has strong asset quality,

- is well-managed, and
- has effective internal risk controls and underwriting standards.

Furthermore, the examiner should not have identified any other matters of significant concern during the examination. In other words, coverage of the core group of loans could be 40 percent only for a bank that received a composite CAMELS rating of 1 or 2 and an asset-quality rating of 1 on its last examination, provided the findings of the current review of the core group of loans appears consistent with these ratings. For banks that have high overall ratings (CAMELS 1 and 2) but a coverage ratio for its core group of loans that is significantly below 40 percent, additional loans should be selected to bring the coverage ratio for all loans reviewed to a minimum 40 percent.

Banking organizations with less than satisfactory composite supervisory ratings or other significant areas of supervisory concern should have loan coverage ratios of at least 55 to 60 percent to fully determine the financial condition of the organization. Any divergence from these guidelines should be fully documented in the confidential section of the examination report.

The examiner should use his or her conclusions from the review of the core group of loans to determine the extent to which additional loans should be selected for review, as these loans will provide the most up-to-date indications of the general condition of the bank's loan portfolio and the adequacy of the bank's credit-administration practices. For example, if the review of the core group of loans reveals that an undue proportion of a bank's problem assets are concentrated in a particular type of loan or if a portion of the portfolio is growing rapidly, the additional loans to be reviewed should be selected from that group.

In determining the extent of additional loans to be reviewed, the effectiveness of the bank's internal credit-review and -grading system should also be considered. If, for example, the examiner's review of the core group of loans provides essentially the same results as those from these systems, then the number and dollar size of the remaining sample reviewed can be kept relatively low (unless the review of the remaining sample raises questions about the integrity of the system with respect to the remaining portfolio).

In addition to the coverage ratio of the core group of loans, an examiner should take into

3. One approach to selecting the additional sample of loans to be reviewed is to lower the cutoff level of larger loans subject to review. Alternatively, other methods (including random sampling or selecting recent loans or specific loan types) may be used to select the sample when these methods appear more suited to the bank's circumstances.

4. A loan-review-coverage ratio should be calculated by dividing the dollar volume of commercial and industrial loans and commercial real estate loans reviewed during the examination by a bank's total dollar volume of such credits. For the purposes of this calculation, loans are defined as all sources of credit exposure arising from loans and leases, including guarantees, letters of credit, and other loan commitments. Credit exposures arising from trading and derivatives activities are not generally included in this coverage ratio.

account other factors, including the overall condition of the bank at its last examination and, most importantly, that examination's findings on the quality of the loan portfolio and the adequacy of loan-administration activities (that is, the accuracy of internal loan-rating systems, the appropriateness of underwriting standards, the adequacy of documentation in files, the adequacy of management information and internal control systems, and the adequacy of loan-loss reserves). Other important factors are the ability and experience of the lending officers and personnel managing the lending function, any changes in asset quality or lending policies since the last examination, and significant concentrations identified in the preliminary review of the loan portfolio. Regardless of the total coverage of the core-group review and the additional sample of loans, the examiner must select a sufficient number, volume, and variety of loans to accurately judge the condition of the bank's entire loan and lease portfolio and the effectiveness of its credit-administration policies and practices.

## Commercial Loan Sampling Techniques

Sampling techniques are a valid and efficient method for reviewing the commercial loan portfolios at banks during on-site examinations. Sampling enables the examiner to draw conclusions regarding the condition of the entire loan portfolio by reviewing only a selected portion. These techniques make more efficient use of examination resources and allow examiners to devote more of their time and efforts to other areas of the examination.

Generally, a judgmental sampling technique is used for reviewing commercial loans. This technique enables examiners to evaluate the portfolio by reviewing a desired percentage of all the loans over a preselected cutoff amount. In addition to the judgmental sampling approach, statistical sampling techniques can also be valid methods for evaluating loan portfolios. Two statistical sampling techniques that may be selectively implemented during on-site examinations are attributes sampling and proportional sampling. Attributes sampling is especially well-suited for large banks that have formal loan review programs; proportional sampling may be better suited for smaller or regional banks without internal loan-review programs.

In statistical sampling, the examiner uses the concepts of probability to apply sampling techniques to the design, selection, and evaluation of loan samples. Statistical sampling eliminates (or at least minimizes) potential selection biases because each item in the sample-loan population must have an equal or otherwise determinable probability of being included in the examined portion. This probability provides the examiner with a quantitative, controllable measure of risk.

Generally, statistical sampling techniques may be implemented only in those banks (1) that were found to be in financially sound condition, (2) that were without any undue loan portfolio problems at the latest examination, and (3) where it was determined that the systems and controls were appropriate for implementing such techniques. Moreover, if during an examination, the examiner determines that the statistical sampling results are unsatisfactory, the traditional judgmental sampling technique should be implemented.

The two recommended statistical sampling techniques are described below:

- *Attributes Sampling.* The objective of attributes sampling is to determine from a sample, within specified reliability limits, the validity of the bank's internal loan-review program. The reliability limits are determined by the examiner, who formulates a hypothesis about the bank's loan-review program when evaluating its policies, practices, and procedures for loan extensions. The population to be sampled consists of all loans between certain dollar parameters, except for loans reviewed under the shared national credit program and loans to identified problem industries (the latter are reviewed separately during the examination). The lower dollar parameter is an amount that the examiner deems sufficient to achieve the desired coverage of the loan portfolio and is selected in much the same manner as a cutoff line is chosen in judgmental sampling. The upper dollar parameter is an amount over which all loans must be reviewed because of the significant effect each could have on the bank's capital. Loans are selected from the sample population by using a random digit table.

When the selected loans are reviewed, the examiner compares his or her grading with those of the bank's loan-review program. An "error" generally exists if the examiner's grading of a particular loan is significantly

more severe than the bank's grading. If the error rate in the sample is beyond the pre-established reliability limits the examiner is able to accept, all loans over the cutoff amount should be reviewed. If the examiner is satisfied with the sample results, the bank's internal grading will be accepted for all criticized loans that have not been independently reviewed within the sample population. Even when the bank's internal grading is deemed acceptable by the examiner, any loans reviewed and found to be in error will be appropriately classified in the report.

- *Proportional Sampling.* The procedures for proportional sampling are similar to those followed for attributes sampling. The objective of this sampling technique is to determine whether bank management can identify all the criticizable loans in the portfolio. The examiner formulates a hypothesis about the quality of the examined bank's loan administration, based on an analysis of loan policies, practices, and procedures for loan extensions. In proportional sampling, every loan in the sample population is given an equal chance of selection in proportion to its size, so the larger the loan, the more likely it will be selected for review. Examiners grade the loans in the sample and compare these gradings with the bank's problem-loan list.

As in attributes sampling, the examiner specifies the desired precision of the sample, that is, that the true error rate in the bank's problem-loan list should be within a certain range of values. A statistical error occurs whenever the examiner criticizes a loan that is not criticized by the bank. If the error rate is higher than expected, the examiner will review all loans over a cutoff line, which is determined using the same criteria as line selection in judgmental sampling. If the sample results indicate an error rate within expectations, then the examiner will accept the bank's problem-loan list as a reliable list of the nonpass loans in the population from which the sample was taken. The examiner will then review and grade each loan on the problem-loan list over the cutoff amount.

For detailed procedures on how to implement both attributes and proportional sampling, examiners should contact either Reserve Bank supervision staff or Federal Reserve Board supervision staff.

## REVIEWING CREDIT QUALITY

### Importance of Cash Flow

Evaluating cash flow is the single most important element in determining whether a business has the ability to repay debt. Two principal methods of calculating the cash flow available in a business to service debt are presented in this subsection. The results of these methods should be used to determine the adequacy of cash flow in each credit evaluated at an institution. The accrual conversion method is the preferred method because it is the most reliable. The second and less reliable method is the supplemental or traditional cash-flow analysis; however, the information needed for this analysis is usually more obtainable and easier to calculate. The traditional method can be used when circumstances warrant, for example, when the borrower's financial statements are not sufficiently detailed for the information requested in the accrual conversion analysis or when historical information is inadequate.

### *Analysis and Limitations of Cash Flow*

Cash-flow analysis uses the income statement and balance sheet to determine a borrower's operational cash flow. Careful analysis of all investment and financing (borrowing) activities must be made for an accurate assessment of cash flow. In reality, examiners face time constraints that often prevent them from performing the complex mathematical calculations involved in sophisticated cash-flow analysis. Therefore, the cash-flow methods presented below were designed to be reasonable and practical for examiner use. *However, examiners should be careful of conclusions reached using the traditional cash-flow analysis, without consideration to balance-sheet changes or other activities that affect cash flow. The traditional cash-flow analysis does not recognize growth in accounts receivable or inventory, a slow-down in accounts payable, capital expenditures, or additional borrowings.* If the credit file contains a CPA-prepared statement of cash flow or a statement prepared using the accrual conversion method, the examiner should concentrate efforts on reviewing and analyzing these statements rather than on preparing a traditional cash-flow statement.



One critical issue to remember is that deficit cash flow does not always mean that the borrower is encountering serious financial difficulties. In some cases, deficit cash flow is caused by a business's experiencing significant growth, and there is a pronounced need for external financing to accommodate this growth and eliminate the deficit cash-flow position. In this case, an adequate working-capital facility may not be in place to accommodate the need for additional inventory. A comprehensive analysis of changes in the balance sheet from period to period should be made before the loan is criticized.<sup>5</sup>

### *Components of the Accrual Conversion Method of Cash Flow*

<i>Category</i>	<i>Basis for Amount</i>
Sales:	Dollar amount of sales in period
+/-change in A/R, INV., A/P:	Represents the absolute difference of the current period from the corresponding period of the previous year in accounts receivable, inventory, and accounts payable.
Formula:	(a) An increase in any current asset is a use of cash and is subtracted from the calculation. Conversely, a decrease in any current asset is a source of cash and is added to the calculation.  (b) An increase in any current liability is a source of cash and is added to the calculation. Conversely, a decrease in any current liability is a use of cash and is subtracted from the calculation.
SGA:	Subtract selling, general, and administrative expenses.
Interest Expense:	Add interest expense to the calculation if SGA "expense" includes interest expense.

Excess (Deficit) Cash Flow: Represents cash available before debt service.

### *Calculation of Supplemental/Traditional Cash Flow*

Net Income: Amount of net income reported on most recent annual income statement before taxes.

Interest Expense: Add the total amount of interest expense for the period.

Depreciation/Amortization: Add all noncash depreciation and principal amortization on outstanding debt.

Cash Flow before

Debt Service: Indicates net Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA). Amortization should include both principal and interest payments required on debt.

Debt Service: Subtract scheduled principal and interest payments.

Capital

Expenditures: Subtract all capital expenditures for the period.

EQUALS—  
Excess (Deficit)

Cash Flow: Total amount of excess or deficit cash flow for the period after debt service.

Coverage

Ratio: Cash flow before debt service divided by debt service (principal and interest).

### **Importance of Financial Analysis**

While cash-flow analysis is critical in reviewing whether a borrower has the ability to repay individual debt, a review of the borrower's other financial statements can offer information about other sources of repayment, as well as the borrower's overall financial condition and future

5. Examiners should make sure that they are using financial data from consistent periods, that is, year-to-date financial information. Mixing annual financial data with interim financial information can cause misinterpretation of cash flow for a given business cycle or annual period.

prospects. The availability of historical balance-sheet and income information, which allow declining trends to be identified, is critical. Also, it may be appropriate to compare the borrower's financial ratios with the average for the industry overall. Much of the financial information that examiners will review will not be audited; therefore, considerable understanding of general accounting principles is necessary to competently review an unaudited financial statement. The bank should obtain at least annual financial statements from a borrower.

When reviewing a credit file of a borrowing customer of a bank, the following financial information should be available for review: income statement, balance sheet, reconciliation of equity, cash-flow statements, and applicable notes to financial statements. The components for a financial review can be segregated into three areas: operations management, asset management, and liability management. Operations management is derived from the income statement and can be used to assess company sales, cost control, and profitability. Asset management involves the analysis of the quality and liquidity of assets, as well as the asset mix. Liability management covers the analysis of the company's record of matching liabilities to the asset conversion cycle, such as long-term assets being funded by long-term liabilities.

In studying the above forms of management, various ratios will help the examiner form an informed and educated conclusion about the quality of the credit being reviewed. The ratios can be divided into four main categories:

- *Profitability ratios.* These ratios measure management's efficiency in achieving a given level of sales revenue and profits, as well as management's ability to control expenses and generate return on investment. Examples of these ratios include gross margin, operating profit margin, net profit margin, profit to sales ratio, profit to total assets ratio, and direct cost and expense ratios.
- *Efficiency ratios.* These ratios, which measure management's ability to manage and control assets, include sales to assets, inventory days on hand, accounts receivable days on hand, accounts payable days on hand, sales to net fixed assets, return on assets, and return on equity.
- *Leverage ratios.* These ratios compare the funds supplied by business owners with the financing supplied by creditors, and measure debt capacity and ability to meet obligations. These ratios may include debt to assets, debt to net worth, debt to tangible net worth, and interest coverage.
- *Liquidity ratios.* Include ratios such as the current ratio and quick ratio, which measure the borrower's ability to meet current obligations.

## Common "Red Flags"

The symptoms listed below are included to provide an understanding of the common problems or weaknesses examiners encounter in their review of financial information. While one symptom may not justify criticizing a loan, when symptoms are considered in the aggregate, they may help the examiner detect near-term trouble. This list is only a sampling of "red flags" that should prompt further review; examiners should also be able to identify issues that may require further investigation from their cursory review of a borrower's financial statement.

- *A slowdown in the receivables collection period.* This symptom often reveals that the borrower has become more liberal in establishing credit policies, has softened collection practices, or is encountering an increase in uncollected accounts.
- *Noticeably rising inventory levels in both dollar amount and percentage of total assets.* Increases in inventory levels are usually supported by trade suppliers, and financing these increases can be extremely risky, particularly if turnover ratios are declining. The increase in inventory levels or lower turnover ratios may also be related to the borrower's natural reluctance to liquidate excessive or obsolete goods at a reduced price. Many businesses are willing to sacrifice liquidity to maintain profit margins.
- *Slowdown in inventory turnover.* This symptom may indicate overbuying or some other imbalance in the company's purchasing policies, and it may indicate that inventory is slow-moving. If the inventory is undervalued, the actual turnover is even slower than the calculated results.
- *Existence of heavy liens on assets.* Evidence of second and third mortgage holders is a sign of greater-than-average risk. The cost of junior

money is high. Most borrowers are reluctant to use this source of funds unless conventional sources are unavailable.

- *Concentrations of noncurrent assets other than fixed assets.* A company may put funds into affiliates or subsidiaries for which the bank may not have a ready source of information on operations.
- *High levels of intangible assets.* Intangible assets, which shrink or vanish much more quickly than hard assets, usually have very uncertain values in the marketplace. In some cases, however, intangible assets such as patents or trademarks have significant value and should be given considerable credit.
- *Substantial increases in long-term debt.* This symptom causes increasing dependence on cash flow and long-term profits to support debt repayment.
- *A major gap between gross and net sales.* This gap represents a rising level of returns and allowances, which could indicate lower quality or inferior product lines. Customer dissatisfaction can seriously affect future profitability.
- *Rising cost percentages.* These percentages can indicate the business's inability or unwillingness to pass higher costs to the customer or its inability to control overhead expenses.
- *A rising level of total assets in relation to sales.* If a company does more business, it will take more current assets in the form of inventory, receivables, and fixed assets. Examiners should be concerned when assets are increasing faster than sales growth.
- *Significant changes in the balance-sheet structure.* These changes may not be the customary changes mentioned previously, but they are represented by marked changes spread across many balance-sheet items and may not be consistent with changes in the marketplace, profits or sales, product lines, or the general nature of the business.

## REQUIRED MINIMUM DOCUMENTATION STANDARDS FOR LOAN LINE SHEETS

Certain minimum documentation must appear on all line examination sheets to leave an acceptable audit trail and to support the classification of designated loans. Currently, much of this information is often placed on the line ticket automatically by using computer-based loan-

review systems. However, the disposition of the loan and the reasons for that disposition are the most crucial entries on the line ticket. Examiners must document their entries and decide how much of the documentation is required to support the loan-review decision. That decision and a summary of the reasons a loan is passed, listed for special mention, or adversely classified should be provided (preferably in bullet form) on the loan line ticket. Beyond that, the documentation will vary depending on the complexity and profile of the credit. The examiner may provide more detailed information on the collateral, cash flow, and repayment history. This additional information is not mandatory if the rationale for the disposition of the credit is otherwise clear.

The extension of credit line sheets and workpapers should document loan discussion comments, identify the examiner who reviewed the credit, and identify the officer(s) with whom the credit was discussed. Line sheets should also include the examiner's conclusion on the specific credit and the reasons for that conclusion.

As part of a review of examination and supervisory policies and procedures and to promote consistency, the items described below have been implemented as required minimum documentation standards for loan line sheets. These standards recognize a transactional approach in examinations and reflect the efficiencies inherent in a risk-focused approach to examinations. The amount of information that should be documented or included as part of a line sheet may vary depending on the type, complexity, and materiality of the credit. However, all line sheets should include the following information to satisfy the required minimum documentation standards, as set forth by SR-99-25 ("Minimum Documentation Standards for Loan Line Sheets," September 29, 1999). The first seven items are frequently provided through computer-based loan-review systems.

- *Name and location of borrower:* Document the name of the individual or company responsible for repayment of the debt.
- *Notation if the borrower is an insider or a related interest of an insider.* If the borrower is an insider or a related interest of the insider as defined by Regulation O, reflect this association on the line sheet.
- *Business or occupation.* Briefly describe the legal entity and the type of business in which the company is engaged, according to the

following definitions:

- *Corporation.* A business organization that is owned by shareholders who have no inherent right to manage the business. The organization is generally managed by a board of directors that is elected by the shareholders. The file should contain the borrowing resolution indicating which officers from the corporation are authorized to sign on its behalf. Indicate if the corporation is closely held.
- *Partnership.* A business organization, specifically, an association of two or more persons to carry on as co-owners of a business for profit. Indicate if it is a general partnership (GP) or limited partnership (LP). If GP, each partner is fully liable for the firm's debts and actions. If LP, at least one general partner is fully liable, but there will also be a number of partners whose liability is limited to that enumerated by the partnership agreement. Indicate each partner's proportionate interest (such as 25 or 50 percent).
- *Proprietorship.* A form of business organization that is owned and operated by an individual. If the borrower is an individual, include his or her primary occupation.
- *Loan terms.* Include the following loan information<sup>6</sup>:
  - date of origination (note subsequent renewals and/or extensions)
  - repayment terms (for example, maturity, periodic payments, revolving)
  - maturity (restructured loans should be noted as such)
  - interest rate (fixed or variable) (If variable, state the basis (index) upon which the interest rate is determined.)
  - originated amount of the loan
- *Purpose of loan.* Note the purpose of each credit facility.
- *Repayment source.* Indicate the primary and secondary sources of repayment for each credit facility.
- *Collateral summary and value.* Describe collateral and assess the value of the collateral in which the bank maintains a perfected security interest. Values should be supported by some type of document, such as a recent financial statement, formal appraisal, management estimate, or any publication that maintains a current market value of collateral. At a minimum, the collateral assessment should include the following information:
  - collateral value
  - basis for valuation
  - date of valuation
  - control of collateral
  - current lien status
- *Loan officer assigned to the credit and the internal rating of the credit.* Note the name of the loan officer responsible for the loan. Also document the bank's internal risk-rating. The date of the most recent update of the rating should also be noted. Particular attention should be given to the consistency between the loan classification at the current examination and the assessment provided by the bank's internal loan-review department. Significant disparities should be noted in the asset-quality assessment.
- *Total commitment and total outstanding balances.* Indicate the total amount of the bank's legal commitment or line of credit available to the borrower. Note the total outstanding debt to the borrower as of the date of examination.
- *Examination date.* Indicate the as-of date of the examination.
- *Past-due or nonaccrual status.* Indicate the past-due status (current, nonaccrual, and days past due).
- *Amounts previously classified.* Note the loan amount and how the loan was previously classified at the most recent examination (Federal Reserve Bank or state).
- *Loan disposition (pass, special mention, or adverse classification).* Note the credit amount and how the credit is being classified, such as pass, special mention, substandard, doubtful, or loss.
- *Rationale for examiner's conclusions (preferably in bullet form).* Indicate the reasons for passing the credit or extending it for criticism, which should be consistent with the classification descriptions noted in "Classification of Credits," section 2060.1.
- *Name or initials of the examiner reviewing the credit.* Indicate the name or initials of the examiner who reviewed and assigned the classification to the credit.
- *Any significant comments by, or commitments from, management.* Clearly and specifically indicate relevant comments (including man-

6. If the loan is a shared national credit (SNC), this should be noted on the line sheet. A copy of the SNC write-up should be attached to the line sheet, and it is not necessary to provide any additional data.

agement's disagreement with the disposition of the loan, if applicable) that may be considered when determining whether or not to criticize the credit. Comments can include officer's comments noted in the credit file, information derived from discussions with management, questions the examiner may have about the borrower, or any other item deemed appropriate. If management plans to get out of the credit relationship, a workout strategy should be included in this section. Comments should be included as to why management disagrees with any loan classification or how any loan was classified.

- *Any noted documentation exceptions or loan-administration policy or procedural weaknesses, and any contravention of law, regulation, or policy.* Indicate any documentation exception or violation of law, regulation, or policy that would be appropriate to include as part of the report of examination. The examiner may include any technical exception noted from the credit file that would inhibit the ability of the loan officer or the examiner to make an informed and/or competent judgment about the quality of the credit relationship.

When needed, loan line sheets should briefly note that information is not available or that certain information is not reliable due to deficient loan-administration systems and processes, particularly with respect to loan and collateral documentation and collateral values. If such deficiencies are material, a listing of the exceptions should be noted in the examination report. In addition, the effect of these loan-administration weaknesses should be discussed and factored into the risk-management rating.

## Optional Information for Loan Line Sheets

In addition to the above information, additional items should be listed when needed to describe the terms of the credit and/or the disposition accorded to it by the examiners, for example, guarantors, amount of any specific reserve, or amounts previously charged off, as described below:

- *Related debt/tie-ins.* The name, total debt outstanding, and type of borrowings (such as real estate, commercial, installment debt) of the related party might be indicated.

- *Guarantor(s).* If a guarantor exists, the name, amount of the guaranty, and date the guaranty was signed can be noted. A summary and an assessment of data supporting a guaranty may also be included, along with current financial information from the guarantor(s) which the bank should obtain at least annually. Tax returns and supporting schedules, income statements, and other pertinent information on the guarantor(s) may be appropriate under certain circumstances. If a troubled credit, indicate whether the guarantor has exhibited any willingness to financially support the credit.
- *Summary of financial data.* The following information may be appropriate, based on the type and complexity of the loan:
  - key balance-sheet information (current ratio, D/E ratio)
  - key income items (EBITDA—earnings before income taxes, depreciation, and amortization; net income; profit margin)
  - cash-flow coverage (debt-service coverage, interest coverage)
  - source of financial data (company-prepared balance sheet, audited financial statement)
- *Dates and amounts of previous charge-offs.*
- *Specific reserves.* The examiner may indicate whether an amount (allocated reserve) was specifically set aside to absorb any loss from the credit. When evaluating the overall adequacy of the loan-loss reserve, subtract the aggregate of allocated reserves from the total reserve balance, and subtract the aggregate amount of loans for which allocated reserves exist from the total loan balance.
- *The name of the loan officer who may have offered the most pertinent discussion items that affected the classification decision.*

## BANKRUPTCY LAW AND COMMERCIAL LOANS

This section provides examiners with an overview of the United States Bankruptcy Code (the code) chapters that affect commercial and industrial loans. Bankruptcy law is a significant body of law; it would be difficult in this manual to discuss all the issues necessary for comprehensive understanding of the code. This subsection will focus on basic issues that an examiner needs to be familiar with relative to three principal sections of the code: chapters 7, 11, and 13.

## Creditors of a Bankrupt Business

A creditor in bankruptcy is anyone with a claim against a bankrupt business, even if a formal claim is not filed in the bankruptcy case. In bankruptcy court, a claim is defined very broadly. A claim may include a right to payment from a bankrupt business, a promise to perform work, or a right to a disputed payment from the debtor that is contingent on some other event. The two basic types of creditors are secured and unsecured. Secured creditors are those with perfected security interest in specific property, such as equipment, accounts receivable, or any other asset pledged as collateral on a loan. Unsecured creditors are generally trade creditors and others who have not taken a specific interest in property supplied to the bankrupt debtor.

## Voluntary Versus Involuntary Bankruptcy

When a debtor files a bankruptcy petition, it is described as a voluntary bankruptcy filing. The individual or organization does not have to be insolvent to file a voluntary case. Creditors may also file a bankruptcy petition, in which case the proceeding is known as an involuntary bankruptcy. This form of petition can occur in chapters 7 and 11 bankruptcy cases, and the debtor generally must be insolvent. To be deemed insolvent, the debtor must be unable to pay debts as they mature. However, the code does limit who an involuntary action can be sought against.

## Chapter 7—Liquidation Bankruptcy

A chapter 7 action may be filed by virtually any person or business organization that is eligible to file bankruptcy. Chapter 7 bankruptcy can be filed by a sole proprietorship, partnership, corporation, joint stock company, or any other business organization. Restrictions apply to only a few highly regulated businesses, such as railroads, insurance companies, banks, municipalities, and other financial institutions. This chapter is often referred to as “straight liquidation,” or the orderly liquidation of all assets of the entity. Generally, a debtor in a chapter 7 bankruptcy case is released from obligations to pay all dischargeable prebankruptcy debts in exchange for surrendering all nonexempt assets

to a bankruptcy trustee. The trustee liquidates all assets and distributes the net proceeds on a pro rata basis against the allowed claims of unsecured creditors. Secured creditor claims are generally satisfied by possession or sale of the debtor’s assets. Depending on the circumstances, a secured creditor may receive the collateral, the proceeds from the sale of the collateral, or a reaffirmation of the debt from the debtor. The reaffirmed debts are generally secured by property that the debtor can exempt from the bankruptcy estate, such as a home or vehicle. The amount of the reaffirmation is limited to the value of the asset at the time of the bankruptcy filing. Some characteristics of a chapter 7 bankruptcy are described below:

- A trustee is appointed in all chapter 7 bankruptcies and acts as an administrator of the bankruptcy estate. The bankruptcy estate that

is established when the petition is filed becomes the legal owner of the property. The trustee acts to protect the interest of all parties affected by the bankruptcy.

- The trustee has control of all nonexempt assets of the bankrupt debtor.
- The trustee is required to liquidate the estate quickly without jeopardizing the interests of the affected parties.
- The proceeds from the sale pay trustee's fees and other creditors. Trustee fees are determined according to the amount disbursed to the creditors and are a priority claim.
- A chapter 7 bankruptcy is typically completed in 90 days, depending on the time needed to liquidate collateral. Some chapter 7 bankruptcies take years to complete.
- The court may allow the trustee to continue to operate a business, if this is consistent with the orderly liquidation of the estate.

## Chapter 11—Reorganization

Most major or large businesses filing bankruptcy file a chapter 11 reorganization. As in chapter 7, virtually any business can file a chapter 11 reorganization. There are specialized chapter 11 reorganization procedures for certain businesses such as railroads, and chapter 11 is not available to stockbrokers, commodity brokers, or a municipality. The basic concept behind chapter 11 is that a business gets temporary relief or a reprieve from paying all debts owed to creditors. This temporary relief gives the business time to reorganize, reschedule its debts (at least partially), and successfully emerge from bankruptcy as a viable business. The basic assumption underlying a chapter 11 bankruptcy is that the value of the enterprise as a going concern will usually exceed the liquidation value of its assets.

### *Reorganization Plan*

Generally, the debtor has an exclusive 120-day period to prepare and file a reorganization plan. If the debtor's plan has not been confirmed within 180 days of the bankruptcy filing, a creditor may file a plan. A plan can provide for any treatment of creditor claims and equity interest, as long as it meets the requirements set out in the code. For example, a plan must designate substantially similar creditor claims

and equity interest into classes and provide for equal treatment of such class members. A plan must also identify those classes with impaired claims and their proposed treatment. Finally, a method of implementation must be provided. Although plans do not have to be filed by a deadline, the bankruptcy judge will generally place a deadline on the debtor or creditor authorized to prepare the plan.

Some characteristics of a chapter 11 bankruptcy are described below.

- The bankrupt debtor usually controls the business during the bankruptcy proceedings. This arrangement is referred to as "debtor in possession."
- The business continues to operate while in bankruptcy.
- The debtor is charged with the duty of developing a reorganization plan within the first 120 days of the filing. After this period expires, the court may grant this authority to a creditors' committee.
- Once the plan is approved by the bankruptcy court, the debtor's payment of debts is generally limited to the schedule and amounts that are detailed in the reorganization plan.
- A chapter 11 proceeding can be complex and lengthy, depending on the number of creditors, amount of the debts, amount of the assets, and other factors that complicate the proceedings.

## Chapter 13—Wage-Earner Bankruptcy

A chapter 13 bankruptcy is available to any individual whose income is sufficiently stable and regular to enable him or her to make payments under the plan. As long as the individual has regular wages or takes a regular draw from his or her business, the individual may qualify under chapter 13 of the code. Under chapter 13, an individual or married couple can pay their debts over time without selling their property. As a protection to creditors, the money paid to a creditor must equal or exceed the amount that the creditor would get in a liquidation or chapter 7 bankruptcy. Chapter 13 may be used for a business bankruptcy, but only if the business is a proprietorship. In most cases, the business needs to be fairly small to qualify.

Some characteristics of a chapter 13 bankruptcy are described below:

- In most cases, only an individual can file a chapter 13 bankruptcy.
- Secured debt may not exceed \$350,000.
- Unsecured debt may not exceed \$100,000.
- The debtor must propose a good-faith plan to repay as many debts as possible from available income.
- A debtor makes regular payments to a trustee, who disburses the funds to creditors under the terms of the plan.
- The trustee does not control the debtor's assets.
- A chapter 13 bankruptcy may include the debts of a sole proprietorship. The business may continue to operate during the bankruptcy.
- After all payments are made under the plan, general discharge is granted.

## SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT

As a result of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the application of sections 23A and 23B of the Federal Reserve Act was expanded to all federally insured commercial and thrift depository institutions. The passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) affected section 23A by allowing the appropriate federal regulator to revoke the "sister bank" exemption for all financial institutions that are "significantly undercapitalized" or those that are "undercapitalized" and fail to submit and implement capital-restoration plans. In addition, FDICIA prohibits critically undercapitalized banks from engaging in covered transactions that are defined in section 23A without prior written approval from the FDIC. Section 23B was added to the Federal Reserve Act on August 10, 1987, through the Competitive Equality Banking Act of 1987. This new section essentially codified additional limitations regarding transactions banks have with their nonbank affiliates. Previously, these transactions had been governed only by Federal Reserve policy or interpretation. The intent of this subsection is to provide examiners with general guidance on how to identify potential violations of these sections of the Federal Reserve Act as it pertains to the commercial-lending function. (Specific guidance and definitions can be obtained from part I of the *Federal Reserve Regulatory Service*.)

## Section 23A

Section 23A of the Federal Reserve Act was designed to prevent misuse of a bank's resources stemming from non-arm's-length transactions with affiliates. Examiners will first need to determine if the institution and counterparty involved in a transaction are affiliates. Once this relationship is determined, the examiner will need to decide if the transaction is included in the statute as a "covered transaction." Generally, covered transactions within the lending function of the institution would include any loan or extension of credit to an affiliate as defined by section 23A. Any transaction by a bank with any person is deemed to be a transaction with an affiliate to the extent that the affiliate benefited from the transaction. A key element of section 23A is that covered transactions between a bank and its affiliate must be on terms and conditions consistent with safe and sound banking practices.

Once the examiner has determined that the counterparty is an affiliate and that the transaction is a covered transaction, there are quantitative limitations that apply. Section 23A limits the covered transaction between a bank and its affiliate to no more than 10 percent of the bank's capital and surplus (defined as capital stock, surplus, retained earnings, and reserves for loan losses). In addition, an institution and its subsidiaries may only engage in a covered transaction with an affiliate if, in the case of all affiliates, the aggregate amount of the covered transactions of the institution and its subsidiaries will not exceed 20 percent of the capital stock and surplus of the institution.

When the transaction involves an extension of credit to a defined affiliate, certain collateral requirements must also be met. Generally, extensions of credit require certain collateral margins that are tied to the type of collateral. For example, extensions of credit that are secured by U.S. Treasury securities or its agencies require a collateral margin of 100 percent of the transaction amount, whereas collateral consisting of stock, leases, or other real or personal property requires a margin of 130 percent. Some collateral, such as the obligations of an affiliate, is not eligible. Certain exemptions to collateral requirements were included to permit transactions that posed little risk to the bank and to prevent undue hardship among the affiliated organizations in carrying out customary transactions with related



entities. These exemptions include various transactions that are related to sister-bank relationships, correspondent relationships, uncollected items, or loans to affiliates secured by riskless collateral.

## Section 23B

With respect to affiliates, section 23B defines affiliates in the same manner as section 23A, except that all banks are excluded from section 23B as affiliates. The principal requirements of section 23B state that any transaction between a bank and a defined affiliate under the act must be (1) on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies, or (2) in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered or would apply to nonaffiliated companies. In short, the terms and conditions of an extension of credit to an affiliate under section 23B should be no more favorable than those that would be extended to any other borrowing customer of the bank. For covered transactions, all transactions that are covered under section 23A are covered under section 23B; however, section 23B expanded the list to include other transactions such as the sale of securities or the receipt of money or services from an affiliate.

The focus of section 23B is different from that of section 23A. Section 23A contains quantitative and collateral restrictions to protect the bank; section 23B focuses on whether transactions with nonbank affiliates are arm's length and not injurious to the bank. Occasionally, an extension of credit, by definition, is granted to an affiliate of a federally insured bank or thrift institution, so examiners are reminded that it is likely that sections 23A and 23B will be implicated. Essentially, examiners need to keep one basic principal in mind: If money flows from the bank to an affiliate other than through a dividend, the transaction is probably a covered transaction and would be enforceable under sections 23A and 23B.

## TIE-IN ARRANGEMENTS

Section 106(b) of the Bank Holding Company

Act Amendments of 1970 prohibits banks from directly tying products or services offered by the bank or any of its affiliates. In the typical tie-in arrangement, whether or not credit is extended or a service is provided (or the amount charged for the credit or service) depends upon the customer's obtaining some additional product or service from the bank or its affiliate or providing some additional product or service to the bank or its affiliate. The intent of section 106(b) was to affirm the principles of fair competition by eliminating the use of tie-in arrangements that suppress competition. Specifically, the section prevents banks from using their marketing power over certain products, specifically credit, to gain an unfair competitive advantage. There are two exceptions to the anti-tying restrictions. The bank may vary the consideration charged for a traditional bank product on the condition or requirement that a customer also obtain a traditional bank product from an affiliate. This exception is a limited extension of the traditional bank product exception provided in section 106. The second exception applies to securities brokerage services (only those activities authorized under section 225.28(b)(7) of Regulation Y). A bank may vary the consideration charged for securities brokerage services on the condition that a customer also obtain a traditional bank product from that bank or its affiliate.

On April 19, 1995, the Board issued a final rule on the anti-tying provisions of section 106 of the 1970 Bank Holding Company Act Amendments. The rule establishes a "combined-balance discount" safe harbor for a banking organization offering varieties of services to its customers and wishing to offer them discounts based on the customers' overall relationship with the bank or its holding company and subsidiaries. The amendment, effective May 26, 1995, provides that a bank holding company or any bank or nonbank subsidiary thereof may weight products as it sees fit in connection with its evaluation of combined-balance discount arrangements, so long as deposits receive an equal or higher weight than other products. The new rule expanded the Board's recent exemption to a large regional banking organization to all banking organizations tying traditional services, such as checking accounts and nontraditional banking products like brokerage services. It permits banks to market products more efficiently and compete more effectively with their nonbanking competitors who currently offer combined-balance discount arrangements.

Examiners should be aware that the principal motive of section 106(b) is to eliminate any potential for “arm twisting” customers into buying some other product to get the product they desire. Examiners should focus on potentially illegal tie-in arrangements by reviewing (1) the banking organization’s internal controls and procedures and its written policies and procedures in this area; (2) the training provided

to the organization’s staff; (3) pertinent extensions of credit to borrowers whose credit facilities or services may be susceptible to improper tie-in arrangements imposed by the bank or company in violation of section 106(b) or the Board’s regulations; and (4) where applicable, the firewalls that have been established between banks and their holding companies and nonbank affiliates, including section 20 subsidiaries.

# Commercial and Industrial Loans

## Examination Objectives

Effective date May 1996

## Section 2080.2

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1. To determine if lending policies, practices, procedures, and internal controls for commercial and industrial loans are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the portfolio for credit quality, performance, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

# Commercial and Industrial Loans Examination Procedures

Effective date November 2003

## Section 2080.3

1. If selected for implementation, complete or update the commercial loan section of the internal control questionnaire.
2. On the basis of the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal or external auditors, and determine if corrections have been accomplished.
4. Obtain a trial balance of the customer liability records.
  - a. Agree or reconcile balances to department controls and the general ledger.
  - b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination. Prepare credit line cards.
6. Obtain the following information from the bank or other examination areas, if applicable:
  - a. past-due loans
  - b. loans in a nonaccrual status
  - c. loans on which interest is not being collected in accordance with the terms of the loan (Particular attention should be given to loans that have been renewed with interest being rolled into principal.)
  - d. loans whose terms have been modified by a reduction of interest-rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms
  - e. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
  - f. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
  - g. loan commitments and other contingent liabilities
  - h. loans secured by stock of other depository institutions
  - i. extensions of credit to employees, officers, directors, and principal shareholders and their interests, specifying which officers are considered executive officers
  - j. extensions of credit to executive officers, directors, and principal shareholders and their interests of correspondent banks
  - k. a list of correspondent banks
  - l. miscellaneous loan-debit and credit-suspense accounts
  - m. Shared National Credits
  - n. loans considered “problem loans” by management
  - o. specific guidelines in the lending policy
  - p. each officer’s current lending authority
  - q. any useful information resulting from the review of the minutes of the loan and discount committee or any similar committee
  - r. reports furnished to the loan and discount committee or any similar committee
  - s. reports furnished to the board of directors
  - t. loans classified during the previous examination
  - u. the extent and nature of loans serviced
7. Review the information received, and perform the following procedures.
  - a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.*
    - Participations only:
      - Test participation certificates and records, and determine that the parties share in the risks and contractual payments on a pro rata basis.
      - Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
      - Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
    - Procedures pertaining to all transfers:
      - Investigate any situations in which loans were transferred immediately before the date of examination to determine if any were trans-

- ferred to avoid possible criticism during the examination.
- Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
  - Determine that the consideration received for low-quality loans transferred from the bank to an affiliate is properly reflected on the bank's books and is equal to the fair market value of the transferred loans. (While fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium.) Section 23A of the Federal Reserve Act generally prohibits a state member bank from purchasing a low-quality asset.
  - Determine that low-quality loans transferred to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.
  - If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
    - (1) name of originating institution
    - (2) name of receiving institution
    - (3) type of transfer (i.e., participation, purchase or sale, swap)
    - (4) date of transfer
    - (5) total number of loans transferred
    - (6) total dollar amount of loans transferred
    - (7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
    - (8) any other information that would be helpful to the other regulator
- b. *Miscellaneous loan-debit and credit-suspense accounts.*
    - Discuss with management any large or old items.
    - Perform additional procedures as deemed appropriate.
  - c. *Loan commitments and other contingent liabilities.* Analyze the commitment or contingent liability if the borrower has been advised of the commitment and the combined amount of the current loan balance (if any) and the commitment or other contingent liability exceeds the cutoff.
  - d. *Loans classified during the previous examination.*
    - current balance and payment status, or
    - date the loan was repaid and the source of payment

Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank, or as a result of a participation, sale, or swap with another lending institution. If repayment was a result of a participation, sale, or swap, refer to step 7a of this section for the appropriate examination procedures.
  - e. *Review of leveraged buyouts.*
    - In evaluating individual loans and credit files, pay particular attention to the reasonableness of interest-rate assumptions and earnings projections relied on by the bank in extending the loan; the trend of the borrowing company's and the industry's performance over time and the history and stability of the company's earnings and cash flow, particularly over the most recent business cycle; the relationship between the company's cash-flow and debt-service requirements and the resulting margin of debt-service coverage; and the reliability and stability of collateral values and the adequacy of collateral coverage.
    - In reviewing the performance of individual credits, attempt to determine if debt-service requirements are being covered by cash flow generated by the company's operations or whether the debt-service requirements are being met out of the proceeds of additional or ancillary loans from the bank designed to cover interest changes.

- Review policies and procedures pertaining to leveraged buyout financing to ensure that they incorporate prudent and reasonable limits on the total *amount* and *type* (by industry) of exposure that the bank can assume through these financing arrangements.
  - Review the bank's pricing, credit policies, and approval procedures to ensure that rates are reasonable in light of the risks involved and that credit standards are not compromised in order to increase market share. Credit standards and internal review and approval standards should reflect the degree of risk and leverage inherent in these transactions.
  - Total loans to finance leveraged buyouts should be treated as a potential concentration of credit. If, in the aggregate, these loans are sufficiently large in relation to capital, the loans should be listed on the concentrations page in the examination report.
  - Discuss significant deficiencies or risks regarding a bank's leveraged buyout financing on page 1 of the examination report, and bring them to the attention of the board of directors.
- f. *Uniform review of Shared National Credits.*
- Compare the schedule of commercial credits included in the uniform review of the Shared National Credit Program with the loans being reviewed to determine which loans are portions of Shared National Credits.
  - For each loan so identified, transcribe appropriate information from the schedule to line cards. (No further examination procedures are necessary for these credits.)
8. Consult with the examiner responsible for the asset/liability management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources. See "Instructions for the Report of Examination," section 6000.1, for considerations to be taken into account when compiling maturity information for the gap analysis.
9. Transcribe or compare information from the schedules to commercial line cards, where appropriate.
10. Prepare commercial line cards for any loan not in the sample that, based on information derived from the above schedules, requires in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, lease financing, and other loan areas, and together decide who will review the borrowing relationship.
12. Add collateral data to line cards selected in the preceding steps.
13. Obtain credit files for all borrowers for whom commercial line cards were prepared, and complete line cards. To analyze the loans, perform the following procedures:
- a. Analyze balance-sheet and profit-and-loss items as reflected in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
  - b. Review components of the balance sheet as reflected in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
  - c. Review supporting information for the major balance-sheet items and the techniques used in consolidation, if applicable, and determine the primary sources of repayment and evaluate their adequacy.
  - d. Ascertain compliance with provisions of loan agreements.
  - e. Review digests of officers' memoranda, mercantile reports, credit checks, and correspondence to determine the existence of any problems that might deter the contractual liquidation program.
  - f. Relate collateral values to outstanding debt.
  - g. Compare interest rates charged with the interest-rate schedule, and determine that the terms are within established guidelines.
  - h. Compare the original amount of loan with the lending officer's authority.
  - i. Analyze secondary support afforded by guarantors and endorsers.
  - j. Ascertain compliance with the bank's established commercial loan policy.
  - k. Determine whether public officials are receiving preferential treatment and

- whether there is any correlation between loans to public officials and deposits they may control or influence.
14. For selected loans, check the central liability file on borrowers indebted above the cutoff or borrowers displaying credit weakness or suspected of having additional liability in other loan areas.
  15. Transcribe significant liability and other information on officers, principals, and affiliations of appropriate borrowers contained in the sample. Cross-reference line cards to borrowers, where appropriate.
  16. Prepare "Report of Loans Supported by Bank Stock," if appropriate. Determine if a concentration of any bank's stock has been pledged.
  17. Determine compliance with laws, rulings, and regulations pertaining to commercial lending by performing the following steps.
    - a. *Lending limits.*
      - Determine the bank's lending limits as prescribed by state law.
      - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    - b. *Section 23A, Relations with Affiliates (12 USC 371c), and section 23B, Restrictions on Transactions with Affiliates (12 USC 371c-1), of the Federal Reserve Act, and Regulation W.*
      - Obtain a listing of loans to affiliates.
      - Test-check the listing against the bank's customer liability records to determine its accuracy and completeness.
      - Obtain a listing of other covered transactions with affiliates (i.e., purchase of loans from affiliates or acceptance of affiliates' securities as collateral for loan to any person).
      - Ensure that covered transactions with affiliates do not exceed the limits of section 23A and Regulation W.
      - Ensure that covered transactions with affiliates meet the appropriate collateral requirements of section 23A and Regulation W.
      - Determine that low-quality loans have not been purchased from an affiliate.
      - Determine that all covered transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
      - Determine that all transactions with affiliates comply with the market-terms requirement of section 23B and Regulation W.
- c. *18 USC 215, Receipt of Commission or Gift for Procuring Loans.*
    - While examining the commercial loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
    - Investigate any such suspected situation.
  - d. *Federal Election Campaign Act (2 USC 441b), Political Contributions.*
    - While examining the commercial loan area, determine the existence of any loans in connection with any political campaigns.
    - Review each such credit to determine whether it is made in accordance with applicable banking laws and in the ordinary course of business.
  - e. *12 USC 1972, Tie-In Provisions.* While reviewing credit and collateral files (especially loan agreements), determine whether any extension of credit is conditioned upon—
    - obtaining or providing an additional credit, property, or service to or from the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service;
    - the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit. (See "Tie-In Considerations of the BHC Act," section 3500.0 of the *Bank Holding Company Supervision Manual*.)
  - f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows (the examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment):

- *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests.* While reviewing information relating to insiders that is received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps)—
  - test the accuracy and completeness of information about commercial loans by comparing it with the trial balance or loans sampled;
  - review credit files on insider loans to determine that required information is available;
  - determine that loans to insiders do not contain terms more favorable than those afforded other borrowers;
  - determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features;
  - determine that loans to insiders, as defined by the various sections of Regulation O, do not exceed the lending limits imposed by those sections;
  - if prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained;
  - determine compliance with the various reporting requirements for insider loans;
  - determine that the bank has made provisions to comply with the public disclosure requirements of Regulation O; and
  - determine that the bank maintains records of such public requests and the disposition of the requests for a period of two years after the dates of the requests.
- *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
  - Obtain from or request that the examiners reviewing due from banks and deposit accounts verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
    - Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.
- g. *12 USC 1828(v), Loans Secured by Bank Stock.*
  - While examining the commercial loan area, determine the existence of any loans or discounts that are secured by the insured financial institution's own stock.
  - In each case, determine that the chief executive officer has promptly reported such fact to the proper regulatory authority.
- h. *12 USC 83 (Rev. Stat. 5201), made applicable to state member banks by section 9, para. 6, of the Federal Reserve Act (12 USC 324), Loans Secured by Own Stock (see also 3-1505 in the Federal Reserve Regulatory Service).*
  - While examining the commercial loan area, determine the existence of any loans secured by the bank's own shares or capital notes and debentures.
  - Confer with the examiner assigned to investment securities to determine whether the bank owns any of its own shares or its own notes and debentures.
  - In each case in which such collateral or ownership exists, determine whether the collateral or ownership was taken to prevent loss on a debt previously contracted (DPC) transaction.
- i. *Regulation U (12 CFR 221).* While reviewing credit files, check the following for all loans that are secured directly or indirectly by margin stock and that were extended for the purpose of buying or carrying margin stock:
  - Except for credits specifically exempted under Regulation U, determine that the required Form FR U-1 has been executed for each credit by the customer and that it has been signed and accepted by a duly authorized officer of the bank acting in good faith.
  - Determine that the bank has not extended more than the maximum loan value of the collateral securing such credits, as set by section 221.7 of Regulation U, and that the margin requirements are being maintained.



- j. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103), Retention of Credit Files.*
- Determine compliance with other specific exceptions and restrictions of the regulation as they relate to the credits reviewed.
  - Review the operating procedures and credit file documentation, and determine if the bank retains records of each extension of credit over \$10,000, specifying the name and address of the borrower, the amount of credit, the nature and purpose of the loan, and the date thereof. (See 31 CFR 103.33.) (Loans secured by an interest in real property are exempt.)
18. Determine whether the consumer compliance examination uncovered any violations of law or regulation in this department. If violations were noted, determine whether corrective action was taken. Test for subsequent compliance with any law or regulation so noted.
19. Perform the appropriate procedural steps in "Concentration of Credits," section 2050.3.
20. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
- a. delinquent loans
  - b. violations of laws and regulations
  - c. loans not supported by current and complete financial information
  - d. loans on which collateral documentation is deficient
  - e. concentrations of credits
  - f. criticized loans
  - g. inadequately collateralized loans
  - h. Small Business Administration or other government-guaranteed delinquent or criticized loans
  - i. transfers of low-quality loans to or from another lending institution
- j. extensions of credit to principal shareholders, employees, officers, directors, and related interests
- k. other matters regarding the condition of the department
21. Inform the Reserve Bank of all criticized participation loans that are not covered by the Shared National Credit Program. Include the names and addresses of all participating state member banks and copies of loan classification comments. (This step deals with loans that deteriorated subsequent to participation and does not duplicate step 7a, which deals with transfers of loans that were of low quality when transferred).
22. Inform the Reserve Bank of those loans eligible for the Shared National Credit Program that were not previously reviewed. Include the names and addresses of all participants and the amounts of their credit. (This step applies only to credits for which the bank under examination is the lead bank.)
23. Evaluate the function for—
- a. the adequacy of written policies relating to commercial loans,
  - b. the manner in which bank officers are operating in conformance with established policy,
  - c. adverse trends within the commercial loan department,
  - d. the accuracy and completeness of the schedules obtained from the bank,
  - e. internal control deficiencies or exceptions,
  - f. recommended corrective action when policies, practices, or procedures are deficient,
  - g. the competency of departmental management, and
  - h. other matters of significance.
24. Update the workpapers with any information that will facilitate future examinations.

# Commercial and Industrial Loans

## Internal Control Questionnaire

Effective date March 1984

## Section 2080.4

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

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written commercial loan policies that:
  - a. Establish procedures for reviewing commercial loan applications?
  - b. Define qualified borrowers?
  - c. Establish minimum standards for documentation?
2. Are commercial loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

- \*3. Is the preparation and posting of subsidiary commercial loan records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
  - c. Approve loans?
  - d. Reconcile subsidiary records to the general ledger?
- \*4. Are the subsidiary commercial loan records reconciled daily with the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?
5. Are delinquent account collection requests and past-due notices checked to the trial balances that are used in reconciling commercial loan subsidiary records with general ledger accounts, and are they handled only by persons who do not also handle cash?
6. Are inquiries about loan balances received

and investigated by persons who do not also handle cash?

- \*7. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash (if so, explain briefly)?
8. Is a daily record maintained summarizing note transaction details, i.e., loans made, payments received, and interest collected, to support applicable general ledger account entries?
9. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?
10. Is an overdue account report generated frequently (if so, how often \_\_\_\_\_)?
11. Are subsidiary payment records and files pertaining to serviced loans segregated and identifiable?
12. Do loan records provide satisfactory audit trails which permit the tracing of transactions from initiation to final disposition?

### LOAN INTEREST

- \*13. Is the preparation and posting of interest records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
14. Are any independent interest computations made and compared or tested to initial interest record by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?

### COLLATERAL

15. Are multicopy, prenumbered records maintained that:
  - a. Detail the complete description of collateral pledged?
  - b. Are typed or completed in ink?
  - c. Are signed by the customer?
  - d. Are designed so that a copy goes to the customer?
- \*16. Are the functions of receiving and releasing collateral to borrowers and of making

- entries in the collateral register performed by different employees?
17. Is negotiable collateral held under joint custody?
  18. Are receipts signed by the customer obtained and filed for released collateral?
  - \*19. Are securities and commodities valued and margin requirements reviewed at least monthly?
  20. When the support rests on the cash surrender value of insurance policies, is a periodic accounting received from the insurance company and maintained with the policy?
  21. Is a record maintained of entry to the collateral vault?
  22. Are stock powers filed separately to bar negotiability and to deter abstraction of both the security and the negotiating instrument?
  23. Are securities out for transfer, exchange, etc., controlled by prenumbered temporary vault-out tickets?
  24. Has the bank instituted a system which:
    - a. Ensures that security agreements are filed?
    - b. Ensures that collateral mortgages are properly recorded?
    - c. Ensures that title searches and property appraisals are performed in connection with collateral mortgages?
    - d. Ensures that insurance coverage (including loss payee clause) is in effect on property covered by collateral mortgages?
  25. Are coupon tickler cards set up covering all coupon bonds held as collateral?
  26. Are written instructions obtained and held on file covering the cutting of coupons?
  27. Are coupon cards under the control of persons other than those assigned to coupon cutting?
  28. Are pledged deposit accounts properly coded to negate unauthorized withdrawal of funds?
  29. Are acknowledgments received for pledged deposits held at other banks?
  30. Is an officer's approval necessary before collateral can be released or substituted?
  32. Are all loan rebates approved by an officer and made only by official check?
  33. Does the bank have an internal review system that:
    - a. Re-examines collateral items for negotiability and proper assignment?
    - b. Checks values assigned to collateral when the loan is made and at frequent intervals thereafter?
    - c. Determines that items out on temporary vault-out tickets are authorized and have not been outstanding for an unreasonable length of time?
    - d. Determines that loan payments are promptly posted?
  34. Are all notes assigned consecutive numbers and recorded on a note register or similar record? Do numbers on notes agree to those recorded on the register?
  35. Are collection notices handled by someone not connected with loan processing?
  36. Are payment notices prepared and mailed by someone other than the loan teller?
  37. Does the bank prohibit the holding of debtor's checks for payment of loans at maturity?
  - \*38. Concerning livestock loans:
    - a. Are inspections made at the inception of credit?
    - b. Are inspections properly dated and signed?
    - c. Is there a breakdown by sex, breed, and number of animals in each category?
    - d. Is the condition of the animals noted?
    - e. Are inspections required at least annually?
  - \*39. Concerning crop loans:
    - a. Are inspections of growing crops made as loans are advanced?
    - b. Are disbursements closely monitored to ensure that the proceeds are properly channeled into the farmer's operation?
    - c. Is crop insurance encouraged?
  40. In mortgage warehouse financing, does the bank hold the original mortgage note, trust deed, or other critical document, releasing only against payment?
  41. Concerning commodity lending:
    - a. Is control for the collateral satisfactory, i.e., stored in the bank's vault, another bank, or a bonded warehouse?
    - b. If collateral is not stored within the bank, are procedures in effect to ascertain the authenticity of the collateral?
    - c. Does the bank have a documented

## OTHER

31. Are notes safeguarded during banking hours and locked in the vault overnight?

- security interest in the proceeds of the future sale or disposition of the commodity as well as the existing collateral position?
- d. Do credit files document that the financed positions are and remain fully hedged?
42. Concerning loans to commodity brokers and dealers:
- a. Does the bank maintain a list of the major customer accounts on the brokers or dealers to whom it lends? If so, is the list updated on a periodic basis?
- b. Is the bank aware of the broker-dealer's policy on margin requirements and the basis for valuing contracts for margin purposes (i.e., pricing spot vs. future)?
- c. Does the bank attempt to ascertain whether the positions of the broker-dealer's clients that are indirectly

financed by bank loans remain fully hedged?

## CONCLUSION

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

# Loan-Sampling Program for Certain Community Banks

## Section 2082.1

Effective date May 2003

A statistically based sampling approach to loan reviews can serve as an alternative to the traditional “top-down” loan-coverage approach when scoping certain bank examinations. In some cases, sampling requires fewer loans<sup>1</sup> to be reviewed than would be required using the minimum-coverage approach, while in other cases it requires more. The results depend heavily on the number of commercial and industrial loans (C&I) and commercial real estate (CRE) loans and the structure of the loan portfolio. Asset size and the level of tier 1 capital also affect the sample size. Additionally, sampling may require fewer loans to be reviewed than under the traditional method in well-managed institutions whose portfolios are not dominated by a small number of relatively large exposures.

Significantly, sampling may provide examiners with a broader perspective on the accuracy of the bank’s classification process than is typically provided by the traditional minimum-coverage target approach. At present, the sampling approach should be directed towards banks currently having a CAMELS composite and asset-quality rating of 1 or 2 and also assets of less than \$1 billion. At present, the sampling approach should be directed towards banks currently having a CAMELS composite and asset-quality rating of 1 or 2 and also assets of less than \$1 billion. The statistical sampling approach is not recommended, however, for use at de novo banks or other banks with unusually high or low capital ratios. Reserve Banks wishing to experiment with the sampling program at organizations with CAMELS or asset-quality ratings of 3 or above or at larger organizations should contact Board staff so that the examiner’s experience that is gained in this area may be used to develop alternative sampling procedures for these other types of institutions. (See SR-02-19.)

## CONCEPT AND STRUCTURE OF THE SAMPLING TECHNIQUE

The sampling approach builds on procedures examiners currently use to evaluate loan portfolios, which require coverage of a similar “core” group of exposures. The principal difference relates to the manner in which loans outside the core group are selected for review. Under the traditional approach, the largest remaining loans are selected until a desired coverage ratio is achieved. Using sampling, the remaining noncore loans are grouped into several strata, or buckets, based on the size of the borrowing relationship. Loans are randomly selected from each of these buckets proportionate to the dollar value of each bucket relative to the total noncore portfolio. The total number of sampled loans required is determined by the number and size distribution of loans in the bank’s portfolio.

The sampling approach is an effective means to determine if the examiner can rely on the bank’s classification process or whether the examiner must determine the level of classifications by traditional means. Although sampling may, in some cases, require examiners to review more loans than required by the traditional loan-coverage approach, sampling is more likely to detect problems among smaller loans and will provide a broader perspective of the bank’s classifications across the entire portfolio.

In most cases, examiners should expect to find very few misclassifications within the sampled buckets, since those segments would exclude any credits that the bank’s internal procedures have identified as weak and those that the examiner has otherwise identified for specific review (the “core” loans). When the examiner’s classifications agree with the bank’s internal loan classifications, then internal classification totals can be relied upon in calculating the total and weighted asset-classification ratios. However, if misclassifications are found within the sample, internal classifications may underestimate the true extent of problem loans, and the examiner must make adjustments to estimate the actual extent of problems. To make that estimate, the rate of misclassification is applied to the remaining loans in the sampled bucket to derive an estimate of other problems that the examiners would likely find if all the loans were

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1. The term “loans” encompasses all sources of credit exposure arising from loans and leases, including guarantees, letters of credit, and other loan commitments. The sampling methods described in this section select “loans” for review by obligor or related group of obligors (where identifiable). Thus, in the sampling procedures, the term “loan” refers to total credit exposure to an individual obligor or related group of obligors. As this implies, loan amounts referred to in this section should be determined on an exposure basis, including all outstanding notes and commitments.

read. This extrapolated amount of problem loans is then added to the total of specifically identified problems to evaluate the significance of credit weaknesses at the institution. Depending on the severity of misclassifications and the magnitude of problems specifically identified, expansion of the examination scope will probably be necessary to better assess the accuracy of loan grading.

## Specific Procedures

Using electronic loan files provided by the bank (for example, those loan files available in the Automated Loan Examination Review Tool (ALERT) format) and the System's loan-sampling software, examiners are able to construct a variety of core and noncore borrower groups. (See table 1.) The "core" group—bucket 1—consists of several categories of loans that examiners have traditionally reviewed and would continue to review using sampling. These core borrowers include, for instance, the largest exposures and certain large problem or insider loans. The sampling program also permits examiners to select any additional borrower (or borrowers) for review based on the examiner's experience and judgment. These individually selected loans would be placed in the "examiner-selected" group—bucket 2. All loans contained in buckets 1 and 2 would be individually reviewed, not sampled, and examiners would not extrapolate their findings to other loans. All remaining internally identified problem borrowers are included in a separate "problem" group—bucket 3—designated as "discuss only"; these borrowers are not incorporated into the commercial-loan-coverage ratio nor are their findings extrapolated to other loans within the same bucket. However, any borrower in the "problem" group—bucket 3—may be individually selected for review by the examiner. Additionally, if the number of "discuss-only" borrowers in the "problem" group—bucket 3—is large, the examiner may select a number of borrowers to be randomly sampled.

The remaining noncore categories represent "pass" or creditworthy loans, grouped by the size of the borrowing relationship. Buckets 4 through 8 are composed of loans to be randomly sampled. The number of loans selected from buckets 4 through 8 is proportional to its total dollar value relative to the total noncore port-

folio. Thus, if loans in a particular category represent 30 percent of the bank's total noncore exposures, then approximately 30 percent of the number of sampled credits will be drawn from that category. A "custom" group—bucket 4—is available for examiners to target specific borrowers meeting a variety of selection criteria. Buckets 5 through 8 represent all remaining loans in the commercial loan portfolio, segregated by size relative to the bank's tier 1 capital and loan-loss reserve. The results of examiners' findings for these sampled buckets would be extrapolated to the entire group of borrowers not reviewed.

### *Determination of Reliance on a Bank's Internal Classifications*

Once the commercial loans have been selected for review, examiners are expected to use existing credit-analysis techniques as described in this manual to evaluate the borrower's creditworthiness, determine the level of adverse classifications, and identify any discrepancies with the bank's internal classifications.

In performing their analysis of the accuracy of classified credits, examiners should start with the assets internally classified by the bank's rating system and add any pass credits that were misclassified by the bank and downgraded to a classified status during the examiner's credit review. These classified assets are the key component for a "base" weighted asset-classification ratio.

Under the sampling program, the "base" weighted asset-classification ratio must be adjusted upward (extrapolated) to the extent misclassifications were uncovered within the randomly sampled loan buckets. The resulting extrapolated weighted asset-classification ratio is necessary to account for the likelihood that misclassifications uncovered from the sampled loans represent only a small portion of the total misclassified loans throughout the rest of the portfolio that was not reviewed. The extrapolated value provides examiners with a more comprehensive picture of the magnitude of the institution's credit problems.

In many cases, there will be no disagreements between the examiner's credit analysis and the bank's internal classifications. Consequently, there will be no difference between the weighted asset-classification ratio and the extrapolated ratio. Generally, no additional sampling would

Table 1—Groups of Loans Available for Review

<i>Bucket</i>	<i>Description</i>
Nonsampled buckets	
Bucket 1 Core	1A: 10 largest non-insider non-problem-borrower exposures 1B: 5 largest non-insider non-problem-borrower exposures underwritten in the previous 12 months 1C: 10 largest non-insider problem-borrower exposures 1D: 5 largest insider borrower exposures
Bucket 2 Examiner-selected	Examiner optional core group. Examiners may manually select any borrower to review.
Bucket 3 Problem	Problem loans (watch list, >59 days past due, internal ratings, and previously classified). Discuss-only borrowers.
Sampled buckets	
Bucket 4 Custom	Examiners may select to target specific borrowers meeting a variety of criteria.
Bucket 5 >3% T1	Remaining borrower exposures greater than 3 percent of tier 1 capital plus the ALLL.
Bucket 6 2%–3% T1	Remaining borrower exposures between 2 percent and 3 percent of tier 1 capital plus the ALLL.
Bucket 7 1%–2% T1	Remaining borrower exposures between 1 percent and 2 percent of tier 1 capital plus the ALLL.
Bucket 8 0.1%–1% T1	Remaining borrower exposures between 0.1 percent and 1 percent of tier 1 capital plus the ALLL.
Bucket 9 <0.1% T1	Remaining borrower exposures less than 0.1 percent of tier 1 capital plus the ALLL. These loans are not included in the sample.
Bucket 10 Noncommercial	All noncommercial borrowers. Examiners may scope into bucket 2.

be necessary. However, other types of credit-administration weaknesses may be discovered that warrant additional review and, as a result, an additional sample of loans may be selected. In this case, the number of loans selected is left to the examiner's judgment.

In other cases, either minor or significant disagreements will require examiners to more fully investigate the reliance that can be placed on the internal classifications. When there are only a minor number of disagreements within

the sampled loans, examiners should be aware that those seemingly minor disagreements may translate into fairly large differences between the base and extrapolated problem-loan figures. When those differences are significant enough that they would alter an examiner's overall conclusion regarding the accuracy of the bank's loan-grading system, follow-up work is required. In particular, significant differences between the "base" and extrapolated weighted classification ratios should raise concerns as to whether the

institution is systematically misreporting credit problems.

For example, a disagreement may arise between an examiner's analysis and the bank's internal classification of a single credit that was drawn from the sample buckets. Assuming a "base" weighted asset-classification ratio of 4 percent, the disagreed-upon sample loan, when extrapolated, could increase the weighted asset-classification ratio to 7 percent. When the difference between the "base" and extrapolated ratios is not material, it would not be necessary to select additional loans if the ratio difference would not alter the examiner's conclusions regarding the condition of the loan portfolio.

In another situation, there may be disagreement between the examiner's analysis and the bank's internal rating on two small-dollar loans sampled from bucket 8 (borrower exposures between 0.1 percent and 1 percent of tier 1 capital plus the allowance for loan and lease losses (ALLL)). In this example, the bank's "base" weighted asset-classification ratio is calculated to be 3 percent. Individually, these loans do not play a significant role in the level of the "base" ratio. However, when these same disagreed-upon classifications are extrapolated, the result is a significant difference between the "base" ratio and the extrapolated classification ratio of 18.5 percent. This can occur when there are only four loans that are sampled from bucket 8, and the two loans in disagreement account for 40 percent of the dollar volume of the sampled loans. Through extrapolation, 40 percent of the remaining bucket 8 loans would be considered classified, thereby increasing the extrapolated ratio to a level that may cause an examiner to question the reliability of the bank's classification system.

In the preceding example, to rule out the possibility that misclassifications were identified as a matter of chance, examiners should expand their loan coverage by pulling an additional sample from the bucket in which the misclassifications were identified. If the examiner selected four additional borrowers from bucket 8 to review and no new misclassifications were found, the extrapolated ratio would decline to 11 percent. As the base and extrapolated ratios move much closer together, the examiner may have greater confidence in the bank's internal loan-rating system and place greater reliance on bank-identified problems in evaluating the bank's asset quality. However, when reviewing the additional four back-up loans, if the examiner

found one new misclassification, then the extrapolated ratio would be 15 percent. In these cases, it is highly unlikely that the misclassifications were caused by chance, and it is probable that a systematic problem exists in the ability of bank management to correctly risk-rate their commercial loans. Consequently, examiners should closely review the misclassifications and determine if any pattern exists, such as loans generated from a specific originating office or loan officer, or by type of credit extension. In these cases, internal classifications should be deemed unreliable and further credit review should be performed to evaluate the full extent of problem assets. That expanded review should be consistent with the minimum loan coverage of 55 percent to 65 percent or more, as required for banks posing supervisory concerns. (See SR-94-13.)

### Factoring Sampling Results into Examination Findings

An evaluation of a bank's asset-quality rating within CAMELS should take into account both financial and managerial factors as detailed in SR-96-38. When using the sampling approach, the extrapolated weighted classification ratio is to be used as a tool for assessing the extent to which examiners may rely on the bank's internal classifications. To the extent loan sampling indicates that the bank's internal classifications are not reliable, the severity of that fundamental risk-management weakness should be factored into the asset-quality rating as well as the management and the risk-management rating. Results of the statistical loan sampling should be documented in the examination report. (See the examination procedures, section 2082.3, for a detailed description of the required information.)

### Discussions with Management Regarding the Sampling Procedures

The sampling procedure produces an extrapolated estimate of weighted classified assets. The principal use of extrapolation is to provide an estimate of what the weighted asset-classification ratio would be for the entire loan portfolio. The extrapolated ratio will differ significantly from the traditional weighted asset-classification ratio when errors in the bank's internal classification



system are detected through random sampling. Examiners may want to discuss (1) how the errors led to a widening of the loan-review scope and (2) the degree of errors found in the loans pulled beyond the initial sample. Any uncertainties regarding the integrity of the institution's classification system or the extent of its asset-quality problems uncovered from the use

of sampling (that resulted from rating errors) should be discussed with management and included in the examination report, along with any necessary follow-up work required to gain more certainty. Those discussions may center on the number of errors uncovered in sampled and core loans.

# Loan-Sampling Program for Certain Community Banks

## Examination Objectives

Effective date May 2003

## Section 2082.2

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1. To evaluate and improve, using statistical sampling, the comprehensiveness and effectiveness of the examination's credit review of a bank's loan portfolio.
2. To better evaluate, using statistical sampling, a bank's internal credit-review process and also the effectiveness of its credit risk-management practices.
3. To assess the accuracy of the bank's internal credit classifications.

# Loan-Sampling Program for Certain Community Banks

## Examination Procedures

Effective date May 2003

## Section 2082.3

1. Using the Federal Reserve System's loan-sampling software and the electronic files provided by the bank under examination (for example, those in the Automated Loan Examination Review Tool (ALERT) format), develop the bank's core and sampled borrower groups. (See table 1 in section 2082.1.) Follow the "Specific Procedures" of section 2082.1 for selecting loans for review, including those that are to be randomly sampled.
2. Use the bank examination credit-analysis techniques in this manual to—
  - a. evaluate the borrower's creditworthiness,
  - b. determine the level of adverse classifications, and
  - c. identify any discrepancies within the bank's internal classifications.
3. Continue to follow the "Specific Procedures."
  - a. Be especially alert when reviewing loan misclassifications to detect patterns of misclassifications (for example, whether the misclassified loans were generated by a specific originating office or loan officer).
  - b. When misclassifications are identified, be prepared to expand the scope of the loan review.
  - c. Ascertain whether the bank is systematically misreporting credit problems.
4. When it is determined that the bank's internal classifications are unreliable, factor the severity of this risk-management weakness into the asset-quality, management, and risk-management ratings.
5. Include the following information in the examination report (for instance, the information illustrated below):
  - a. Report the traditional weighted asset-classification ratio in the open section of the examination report.
  - b. Report the extrapolated weighted asset-classification ratio, the traditional asset-classification ratio, and the number of errors found in the sampled buckets in the confidential section of the report.
  - c. If an expanded sample was undertaken because of misclassification errors, report in the confidential section the number of additional loans selected, any errors from the expanded sample, and the adjusted weighted and extrapolated asset-classification ratios.

The illustration below is a sample table format that may be used to highlight the sampling findings within the indicated sections of the examination report.

### Loan-Sampling Results—Items to Be Reported in the Examination Report

<i>Open section</i>	
Traditional weighted asset-classification ratio	%
<i>Confidential section</i>	
Extrapolated weighted asset-classification ratio	%
Number of borrowers sampled	
Number of errors in sampled buckets	
Expanded-sample information	
Number of sampled borrowers in expanded review	
Number of errors in expanded review	
Adjusted weighted asset-classification ratio	%
Adjusted extrapolated weighted asset-classification ratio	%

Real estate lending is a major function of most banks. However, the composition of banks' real estate loan portfolios will vary because of differences in the banks' asset size, investment objectives, lending experience, market competition, and location. Additionally, state member banks' lending activity is subject to supervision by state banking regulatory agencies, which may impose limitations, including restrictions on lending territory, types of lending, percentage of assets in real estate loans, loan limits, loan-to-value ratios, and loan terms.

Because of the differences in state banking laws, this section of the manual is only an overview of the Federal Reserve's supervisory and regulatory requirements for a safe and sound real estate lending program. This section also briefly discusses automated valuation models (see SR-11-7) and other collateral-evaluation tools or methods. For specific information on lending limitations and restrictions, refer to the applicable state banking laws. In addition, information related to real estate construction lending is discussed in section 2100.1 of this manual.

### REAL ESTATE LENDING POLICY MANDATED BY FDICIA

A bank's real estate lending policy is a broad statement of its standards, guidelines, and limitations that senior bank management and lending officers are expected to adhere to when making a real estate loan. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation is essential to the bank's management of the lending function.

The policies governing a bank's real estate lending activities must include prudent underwriting standards that are clearly communicated to the institution's management and lending staff. The bank should also have credit-risk control procedures that include, for example, an effective credit-review and -classification process and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. As part of the analysis of a bank's real estate loan portfolio, examiners should review lending policies, loan-administration procedures, and credit-risk con-

trol procedures, as well as the bank's compliance with its own policies.

As mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) (12 USC 1828(c)), the Federal Reserve Board, along with the other banking agencies, adopted in December 1992 uniform regulations prescribing standards for real estate lending. FDICIA defines real estate lending as extensions of credit secured by liens on or interests in real estate or made for the purpose of financing the construction of a building or other improvements to real estate, regardless of whether a lien has been taken on the property.

The Federal Reserve's Regulation H requires an institution to adopt real estate lending policies that are—

- consistent with safe and sound banking practices,
- appropriate to the size of the institution and the nature and scope of its operations, and
- reviewed and approved by the bank's board of directors at least annually.

These lending policies must establish—

- loan portfolio diversification standards;
- prudent underwriting standards that are clear and measurable, including loan-to-value limits;
- loan-administration procedures for the institution's real estate portfolio; and
- documentation, approval, and reporting requirements to monitor compliance with the bank's real estate lending policies.

Furthermore, the bank is expected to monitor conditions in the real estate market in its lending area to ensure that its policies continue to be appropriate for current market conditions.

### GUIDELINES ESTABLISHED PURSUANT TO FDICIA

The criteria and specific factors that a bank should consider in establishing its real estate lending policies are set forth in the Interagency Guidelines for Real Estate Lending Policies (Regulation H, part 208, appendix C (12 CFR

208, appendix C)). These guidelines apply to transactions (including legally binding, but unfunded, lending commitments) originated on or after March 19, 1993.

## Loan Portfolio Management

The bank's lending policies should contain a general outline of its market area; a targeted loan portfolio distribution; and the manner in which real estate loans are made, serviced, and collected. Lending policies should include—

- identification of the geographic areas in which the bank will consider lending;
- establishment of a loan portfolio diversification policy and limits for real estate loans by type and geographic market (for example, limits on higher-risk loans);
- identification of the appropriate terms and conditions, by type of real estate loan;
- establishment of loan-origination and -approval procedures, both generally and by size and type of loan;
- establishment of prudent underwriting standards, including loan-to-value (LTV) limits, that are clear and measurable and consistent with the supervisory LTV limits contained in the interagency guidelines;
- establishment of review and approval procedures for exception loans, including loans with LTV ratios in excess of the interagency guidelines' supervisory limits;
- establishment of loan-administration procedures, including documentation, disbursement, collateral inspection, collection, and loan review;
- establishment of real estate appraisal and evaluation programs consistent with the Federal Reserve's appraisal regulation and guidelines; and
- a requirement that management monitor the loan portfolio and provide timely and adequate reports to the bank's board of directors.

The complexity and scope of these policies and procedures should be appropriate for the market, size, and financial condition of the institution and should reflect the expertise and size of the lending staff. The bank's policies

should also consider the need to avoid undue concentrations of risk and compliance with all real estate-related laws and regulations (such as the Community Reinvestment Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, and antidiscrimination laws).

The bank should monitor the conditions in the real estate markets in its lending area so that it can react quickly to changes in market conditions that are relevant to the lending decision. This should include monitoring market supply-and-demand factors, such as employment trends; economic indicators; current and projected vacancy, construction, and absorption rates; and current and projected lease terms, rental rates, and sales prices.

## Underwriting Standards

The bank's lending policies should reflect the level of risk that is acceptable to its board of directors and should provide clear and measurable underwriting standards that enable the bank's lending staff to evaluate all relevant credit factors. These factors include—

- the capacity of the borrower or income from the underlying property to adequately service the debt;
- the market value of the underlying real estate collateral;
- the overall creditworthiness of the borrower,
- the level of the borrower's equity invested in the property;
- any secondary sources of repayment; and
- any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or takeout commitments.

While there is no one lending policy appropriate for all banks, there are certain standards that a bank should address in its policies, such as—

- the maximum loan amount by type of property,
- the maximum loan maturities by type of property,
- amortization schedules,
- the pricing structure for each type of real estate loan, and
- loan-to-value limits by type of property.

For development and construction projects and completed commercial properties, the bank's policy should also establish appropriate standards for the unique risks associated with these types of real estate loans by addressing the size, type, and complexity of the project. Such standards should include the acceptability of and limits for nonamortizing loans and interest reserves; requirements for pre-leasing and pre-sale; limits on partial recourse or nonrecourse loans; requirements for guarantor support; requirements for takeout commitments; and minimum covenants for loan agreements. Furthermore, the bank's policy should set minimum requirements for initial investment by the borrower; maintenance of hard equity throughout the life of the project; and net worth, cash flow, and debt-service coverage of the borrower or underlying property.

### *Exceptions to Underwriting Standards*

The bank should have procedures for handling loan requests from creditworthy borrowers whose credit needs do not conform with the bank's general lending policy. As a part of the permanent loan file, the bank should document justification for approving such loans. Moreover, in the course of monitoring compliance with its own real estate lending policy, bank management should report to its board of directors loans of a significant size that are exceptions to bank policy. An excessive volume of exceptions to the institution's own policies may signal weaknesses in its underwriting practices or a need to revise its policy.

### *Supervisory Loan-to-Value Limits*

The bank should establish its own internal loan-to-value (LTV) limits for each type of real estate loan that is permitted by its loan policy. The LTV ratio is derived at the time of loan origination by dividing the extension of credit, including the amount of all senior liens on, or other senior interests in, the property, by the total value of the property or properties securing or being improved by the extension of credit, plus the amount of any other acceptable collat-

eral and readily marketable collateral securing the credit.

In accordance with the Federal Reserve's appraisal regulation and guidelines, the value of the real estate collateral should be set forth in an appraisal or evaluation (whichever is appropriate) and should be expressed in terms of market value. However, for loans to purchase an existing property, the term "value" means the lesser of the actual acquisition cost to the borrower or the estimate of value as presented in the appraisal or evaluation. See "Real Estate Appraisals and Evaluations," section 4140.1 of this manual for further discussion of the Federal Reserve's appraisal regulation and guidelines.

"Other acceptable collateral" refers to any collateral in which the lender has a perfected security interest, that has a quantifiable value, and that is accepted by the lender in accordance with safe and sound lending practices. This includes inventory, accounts receivables, equipment, and unconditional irrevocable standby letters of credit.

Readily marketable collateral means insured deposits, financial instruments, and bullion in which the lender has a perfected interest. Financial instruments and bullion must be readily salable under ordinary circumstances at a market value determined by quotations based on actual transactions, on an auction, or similarly available daily bid and asking price.

Other acceptable collateral and readily marketable collateral should be appropriately discounted by the lender consistent with the bank's usual practices for making loans secured by such collateral. The lender may not consider the general net worth of the borrower, which might be a determining factor for an unsecured loan, as equivalent to other acceptable collateral for determining the LTV on a secured real estate loan. Furthermore, if an institution attempts to circumvent the supervisory LTV limits by lending a portion of the funds on a secured basis and a portion on an unsecured basis, examiners are instructed to consider the two loans as one if certain similarities are found. These similarities are based upon facts such as common origination dates or loan purposes, and should be used to determine compliance with the supervisory LTV limits. The bank's policy should reflect the supervisory limits set forth in the Interagency Guidelines for Real Estate Lending Policies, which are shown in the following table.

**Table 1—Supervisory Loan-to-Value Limits**

<i>Loan Category</i>	<i>Loan-to-Value Limit</i>
Raw land	65%
Land development, including improved land loans	75%
Construction:	
Commercial, multifamily, and other nonresidential	80%
One- to four-family residential	85%
Improved property	85%
Owner-occupied one- to four-family and home equity	**

\*\* A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied one- to four-family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

For purposes of these supervisory limits, the loan categories are defined as follows:

*Raw land loan* means an extension of credit in which the funds are used to acquire and/or hold raw land.

*Land development loan* means an extension of credit for the purpose of improving unimproved real property before the erection of any structures. Such improvements include the laying or placement of sewers, water pipes, utility cables, streets, and other infrastructure necessary for future development. This loan category also includes an extension of credit for the acquisition of improved land, such as residential lots in an established development. If there are minimal improvements to the land, and the time-frame for construction of the dwelling or building has not been scheduled to commence in the foreseeable future, the loan generally should be considered a raw land loan.

*Construction loan* means an extension of credit for the purpose of erecting or rehabilitating buildings or other structures, including any infrastructure necessary for development.

*One- to four-family residential loan* means an

extension of credit for a property containing fewer than five individual dwelling units, including manufactured homes permanently affixed to the underlying property.

*Multifamily construction loan* means an extension of credit for a residential property containing five or more individual units, including condominiums and cooperatives.

*Improved property loan* refers to (1) farmland, ranchland, or timberland committed to ongoing management and agricultural production; (2) one- to four-family residential property that is not owner-occupied; (3) residential property containing five or more individual dwelling units; (4) completed commercial property; or (5) other income-producing property that has been completed and is available for occupancy and use, except income-producing owner-occupied one- to four-family residential property.

*Owner-occupied one- to four-family residential property* means that the owner of the underlying real property occupies at least one unit of the real property as a principal residence.

For loans that fund multiple phases of the same real estate project, the appropriate LTV limit is the supervisory LTV limit applicable to the final phase of the project. For example, when the loan is for the acquisition and development of land and the construction of an office building in continuous phases of development, the appropriate supervisory LTV limit for the project loan would be 80 percent (the supervisory LTV limit for commercial construction). However, this does not imply that the lender can finance the total acquisition cost of the land at the time the raw land is acquired by assuming that this financing would be less than 80 percent of the project's final value. The lender is expected to fund the loan according to prudent disbursement procedures that set appropriate levels for the borrower's hard equity contributions throughout the disbursement period and term of the loan. As a general guideline, the funding of the initial acquisition of the raw land should not exceed the 65 percent supervisory LTV limit; likewise, the project cost to fund the land development phase of the project should not exceed the 75 percent supervisory LTV limit.

For a multiple-phase one- to four-family residential loan in which the lender is funding both

the construction of the house and the permanent mortgage to a borrower who will be the owner-occupant, there is no supervisory LTV limit. However, if the LTV ratio equals or exceeds 90 percent, the bank should require an appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

When a loan is fully cross-collateralized by two or more properties, the maximum loan amount is determined by first multiplying each property's collateral value by the LTV ratio appropriate to that property and then deducting from that product any existing senior liens on that property. The resulting sum is the maximum loan amount that may be extended under cross-collateralization. To ensure that collateral margins remain within the supervisory limits, the bank should redetermine conformity whenever collateral substitutions are made to the collateral pool.

### *Loans in Excess of Supervisory LTV Limits*

The Federal Reserve believes that it may be appropriate for a bank, in certain circumstances, to originate or purchase loans with LTV ratios in excess of supervisory limits, based on the support provided by other credit factors that the bank documented in its permanent credit files. While high LTV lending poses higher risk for lenders than traditional mortgage lending, high LTV lending can be profitable when these risks are effectively managed and loans are priced based on risk. Therefore, institutions involved in high LTV lending should implement risk-management programs that identify, measure, monitor, and control the inherent risks (see SR-99-26 and the attached "Interagency Guidance on High LTV Residential Real Estate Lending," October 8, 1998). The primary credit risks associated with this type of lending are increased default risk and losses, inadequate collateral, longer term and thus longer exposure, and limited default remedies.

*Capital limits.* A bank's nonconforming loans—those in excess of the supervisory LTV limits—should be identified in bank records, and the aggregate amount, along with the performance experience of the portfolio, should be reported at least quarterly to the bank's board of directors. There should be increased supervisory scrutiny

of a bank as its level of loans in excess of supervisory LTV limits approaches the capital limitations. Nevertheless, a nonconforming loan should not be criticized solely because it does not adhere to supervisory limits.

The aggregate amount of nonconforming loans may not exceed 100 percent of a bank's total risk-based capital (referred to as the nonconforming basket). Within this limit, the aggregate amount of non-one- to four-family residential loans (for example, raw land, commercial, multifamily, and agricultural loans) that do not conform to supervisory LTV limits may not exceed 30 percent of total risk-based capital. The remaining portion of the nonconforming basket includes the aggregate amount of one- to four-family residential development and construction loans, non-owner-occupied one- to four-family residential loans with an LTV ratio greater than 85 percent, and owner-occupied one- to four-family residential loans with an LTV ratio equal to or exceeding 90 percent without mortgage insurance or readily marketable collateral.

For the purpose of determining the loans subject to the 100 percent of risk-based capital limitation, and for the purposes of determining the aggregate amount of such loans, institutions should include loans that are secured by the *same* property, when the combined loan amount equals or exceeds 90 percent LTV and there is no additional credit support. In addition, institutions should include the recourse obligation of any such loan sold with recourse. If there is a reduction in principal or senior liens or if the borrower contributes additional collateral or equity that brings the LTV ratio into supervisory compliance, the loan is no longer considered nonconforming and may be deleted from the quarterly nonconforming loan report to the directors.

The following guidance is provided for calculating the LTV when multiple loans and more than one lender are involved. The institution should include its loan and all senior liens on or interests in the property in the total loan amount when calculating the LTV ratio. The following examples are provided:

- Bank A holds a first-lien mortgage on a property and subsequently grants the borrower a home equity loan secured by the same property. In this case, the bank would combine both loans to determine if the total amount outstanding equaled or exceeded 90 percent of



the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, the entire amount of both loans is an exception to the supervisory LTV limits and is included in the aggregate capital limitation.

- Bank A grants a borrower a home equity loan secured by a second lien. Bank B holds a first-lien mortgage for the same borrower and on the same property. Bank A would combine the committed amount of its home equity loan with the amount outstanding on Bank B's first-lien mortgage to determine if the LTV ratio equaled or exceeded 90 percent of the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, Bank A's entire home equity loan is an exception to the supervisory LTV limits and is included in the aggregate capital limitation. Bank A does not report Bank B's first-lien mortgage loan as an exception, but must use it to calculate the LTV ratio.

When a loan's LTV ratio is reduced below 90 percent by amortization or additional credit support, it is no longer an exception to the guidelines and may be excluded from the institution's 100 percent of capital limitation.

Institutions will come under increased supervisory scrutiny as the total of all loans in excess of the supervisory LTV limits, including high LTV residential real estate loan exceptions, approaches 100 percent of total capital. If an institution exceeds the 100 percent of capital limit, a supervisory assessment may be needed to determine whether there is any concern that warrants taking appropriate supervisory action. Such action may include directing the institution (1) to reduce its loans in excess of the supervisory LTV limits to an appropriate level, (2) to raise additional capital, or (3) to submit a plan to achieve compliance. The institution's capital level and overall risk profile, and the adequacy of its controls and operations, as well as other factors will be the basis for determining whether such actions are necessary.

### *Transactions Excluded from Supervisory LTV Limits*

There are a number of lending situations in which other factors significantly outweigh the need to apply supervisory LTV limits, thereby

excluding such transactions from the application of the supervisory LTV and capital limits. This includes loans—

- guaranteed or insured by the U.S. government or its agencies, provided the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory LTV limit.
- backed by the full faith and credit of a state government, provided the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory LTV limit.
- guaranteed or insured by a state, municipal, or local government or agency, provided the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory LTV limit and that the guarantor or insurer has the financial capacity and willingness to perform.
- sold promptly (within 90 days) after origination. A supervisory determination may be made that this exclusion is not available for an institution that has consistently demonstrated significant weaknesses in its mortgage banking operations. (If a loan is sold with recourse and the LTV is in excess of supervisory limits, the recourse portion of the loan counts toward the bank's limit for nonconforming loans.)
- renewed, refinanced, or restructured—
  - without the advancement of new monies (except reasonable closing costs); or
  - in conjunction with a clearly defined and documented workout, either with or without the advancement of new funds.
- facilitating the sale of real estate acquired by the lender in the course of collecting a debt previously contracted in good faith.
- in which a lien on real property is taken through an abundance of caution; for example, the value of the real estate collateral is relatively low compared with the aggregate value of other collateral, or a blanket lien is taken on all or substantially all of the borrower's assets.<sup>1</sup>
- for working-capital purposes in which the lender does not rely principally on real estate as security. The proceeds of the loan are not

1. Any residential mortgage or home equity loan with an LTV ratio that equals or exceeds 90 percent and that does not have the additional credit support should be considered an exception to the guidelines and included in the calculation of loans subject to the 100 percent of capital limit.

used to acquire, develop, or construct real property.

- financing permanent improvements to real property, but in which no security interest is taken or required by prudent underwriting standards. For example, a manufacturing company obtains a loan to build an addition to its plant. The bank does not take a lien on the plant because the bank is relying on the company's operating income and financial strength to repay the debt.

### *Risk Management for Supervisory Loan-to-Value Limits*

*Loan review and monitoring.* Institutions should perform periodic quality analyses through loan review and portfolio monitoring. These periodic reviews should include an evaluation of various risk factors, such as credit scores, debt-to-income ratios, loan types, location, and concentrations. At a minimum, the high-LTV loan portfolios should be segmented by their vintage (that is, age) and the performance of the portfolios should be analyzed for profitability, growth, delinquencies, classifications and losses, and the adequacy of the allowance for loan and lease losses based on the various risk factors. The ongoing performance of the high-LTV loans should be monitored by a periodic re-scoring of the accounts, or by periodically obtaining updated credit bureau reports or financial information on borrowers. In addition, institutions involved in high-LTV lending should adopt, as part of their loan-review program, the standards in the FFIEC's Uniform Retail-Credit Classification and Account-Management Policy. (See section 2130.1.)

*Sales of high-LTV loans.* When institutions securitize and sell high-LTV loans, all the risks inherent in such lending may not be transferred to the purchasers. Institutions that actively securitize and sell high-LTV loans must implement procedures to control the risks inherent in that activity. Only written counterparty agreements that specify the duties and responsibilities of each party and that include a regular schedule for loan sales should be entered into. A contingency plan should be developed that designates backup purchasers and servicers in the event that either party is unable to meet its contractual obligations. To manage liquidity risk, commitment limits should be established for the amount

of pipeline and warehoused loans, and alternate funding sources should be identified.

Institutions should refer to the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (a replacement of FASB statement 125)," for guidance on accounting for these types of transactions. If a securitization transaction meets FAS 140 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights or obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations.

*Compliance risk.* Institutions that originate or purchase high-LTV real estate loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory "steering" of borrowers to high-LTV products for reasons other than the borrower's creditworthiness. An adequate compliance-management program must identify, monitor, and control the compliance risks associated with high-LTV real estate lending.

## REAL ESTATE LENDING ACTIVITY AND RISKS

Real estate lending falls into two broad categories: short-term financing (primarily construction loans) and permanent financing (for example, a 30-year residential mortgage or a 10-year mortgage loan with payments based on a 25-year amortization schedule and a balloon payment due at the end of the 10 years on an existing commercial office building). Each type of lending carries with it unique underwriting risks as well as common risks associated with any type of lending. In all cases, the bank should understand the credit risks and structure of the proposed transaction, even if it is not the originating bank. This includes, at a minimum, understanding the borrower's ability to repay the debt and the value of the underlying real estate collateral.

Permanent financing, as the name implies, is long term and presents a funding risk since a bank's source of funds is generally of a shorter maturity. Accordingly, bank management should be aware of the source for funding this lending activity. While matching the maturity structures of assets to liabilities is particularly important for a bank's overall loan portfolio management, the importance of this task is even more evident in real estate lending activity. Many banks reduce their funding risk by entering into loan participations and sales with other institutions as well as asset securitization transactions.<sup>2</sup> For a detailed discussion on short-term financing, see section 2100.1, "Real Estate Construction Loans."

## Unsound Lending Practices

Some banks have adversely affected their financial condition and performance by granting loans based on ill-conceived real estate projects. Apart from losses due to unforeseen economic downturns, these losses have generally been the result of poor or lax underwriting standards and improper management of the bank's overall real estate loan portfolio.

A principal indication of an unsound lending practice is an improper relationship between the loan amount and the market value of the property; for example, a high loan-to-value ratio in relationship to normal lending practice for a similar type of property. Another indication of unsound lending practices is the failure of the bank to examine the borrower's debt-service ability. For a commercial real estate loan, sound underwriting practices are critical to the detection of problems in the project's plans, such as unrealistic income assumptions, substandard project design, potential construction problems, and a poor marketing plan, that will affect the feasibility of the project.

### *Real Estate Loan Portfolio Concentration Risk*

A bank should have in place effective internal policies, systems, and controls to monitor and

manage its real estate loan portfolio risk. An indication of improper management of a bank's portfolio is an excessive concentration in loans to one borrower or related borrowers, in one type of real estate loan, or in a geographic location outside the bank's designated trade area.

In identifying loan concentrations, commercial real estate loans and residential real estate loans should be viewed separately when their performance is not subject to similar economic or financial risks. However, groups or classes of real estate loans should be viewed as concentrations when there are significant common characteristics and the loans are affected by similar adverse economic, financial, or business developments. Banks with asset concentrations should have in place effective internal policies, systems, and controls to monitor and manage this risk.

Concentrations that involve excessive or undue risks require close scrutiny by the bank and should be reduced over a reasonable period of time. To reduce this risk, the bank should develop a prudent plan and institute strong underwriting standards and loan administration to control the risks associated with new loans. At the same time, the bank should maintain adequate capital to protect it from the excessive risk while restructuring its portfolio.

## Loan Administration and Servicing

Real estate loan administration is responsible for certain aspects of loan monitoring. While the administration may be segregated by property type, such as residential or commercial real estate loans, the functions of the servicing department may be divided into the following categories (although the organization will vary among institutions):

- *Loan closing and disbursement*—preparing the legal documents verifying the transaction, recording the appropriate documents in the public land records, and disbursing funds in accordance with the loan agreement.
- *Payment processing*—collecting and applying the loan payments.
- *Escrow administration*—collecting insurance premiums and property taxes from the borrower and remitting the funds to the insurance company and taxing authority.

2. See section 4030.1, "Asset Securitization," for additional information, including information on mortgage-backed securities (MBSs), collateralized mortgage obligations (CMOs), and real estate mortgage investment conduits (REMICs).

- *Collateral administration*—maintaining documents to reflect the status of the bank’s lien on the collateral (i.e., mortgage/deed of trust and title policy/attorney’s opinion), the value of the collateral (i.e., real estate appraisal or evaluation and verification of senior lien, if in existence), and the protection of the collateral (i.e., hazard/liability insurance and tax payments).
- *Loan payoffs*—determining the pay-off amount, preparing the borrower release or assumption documents, confirming the receipt of funds, and recording the appropriate lien-release documents in the public land records.
- *Collections and foreclosure*—monitoring the payment performance of the borrower and pursuing collection of past-due amounts in accordance with bank policy on delinquencies.
- *Claims processing*—seeking recoveries on defaulted loans that are covered by a government guarantee or insurance program or a private mortgage insurance company.

The bank should have adequate procedures to ensure segregation of duties for disbursement and receipt of funds control purposes. Additionally, the procedures should address the need for document control because of the importance of the timely recording of the bank’s security interests in the public land records.

Some institutions provide various levels of loan services for other institutions, which may range from solely the distribution of payments received to the ultimate collection of the debt through foreclosure. In such cases, the bank will have the additional responsibility of remitting funds on a timely basis to the other institutions in accordance with a servicing agreement. The servicing agreement sets forth the servicer’s duties, reporting requirements, timeframe for remitting funds, and fee structure. If a bank relies on another institution for servicing, the bank should have adequate control and audit procedures to verify the performance of the servicer (also see section 4030.1, “Asset Securitization”). For residential loans sold into the secondary mortgage market for which the bank has retained servicing, Fannie Mae, Freddie Mac, and the Government National Mortgage Corporation (Ginnie Mae) have specific standards the bank (that is, seller/servicer) must adhere to. Failure to meet these standards can result in the termination of the servicing agreement.

## BANK ASSESSMENT OF THE BORROWER

Although the value of the real estate collateral is an important component of the loan-approval process, the bank should not place undue reliance on the collateral value in lieu of an adequate assessment of the borrower’s ability to repay the loan. These assessment factors differ depending upon the purpose of the loan, such as single-family residential loans as compared with income-producing commercial property loans and commercial or residential development loans (referred to as “commercial real estate lending”). The loan documentation must adequately support the bank’s assessment of the borrower and contain the appropriate legal documentation to protect the bank’s interests.

### Single-Family Residential Loans

For single-family residential loans, the bank should evaluate the loan applicant’s creditworthiness and whether the individual has the ability to meet monthly mortgage payments as well as all other obligations and expenses associated with home ownership. This includes an assessment of the borrower’s income, liquid assets, employment history, credit history, and existing obligations.<sup>3</sup> The bank should also consider the availability of private mortgage insurance; a government guarantee; or a government insurance program, such as loans through the FHA-insured or VA-guaranteed programs, in assessing the credit risk of a loan applicant.

If a bank delegates the loan-origination function to a third party, the bank should have adequate controls to ensure that its loan policies and procedures are being followed. The controls should include a review of the third party’s qualifications; a written agreement between the bank and the third-party originator to set forth the responsibilities of the third party as an agent for the bank; a periodic review of the third party’s operations to ensure that the bank’s

3. There are restrictions on the information a bank can request. The Federal Reserve’s Regulation B, Equal Credit Opportunity (12 CFR 202), details the information that may and may not be requested on a loan application and provides a model form for a residential mortgage transaction. The Federal Reserve’s Regulation Z, Truth in Lending (12 CFR 226), describes the bank-disclosure requirements to the potential borrower on the cost of financing.

policies and procedures are being adhered to; and development of quality controls to ensure that loans originated by the third party meet the bank's lending standards, as well as those of the secondary mortgage market if the bank expects to sell the mortgages.

## Secondary Residential Mortgage Market

In the secondary market, a bank (the primary mortgage originator) sells all or a portion of its interest in residential mortgages to other financial institutions (investors). Thus, the secondary mortgage market provides an avenue for a bank to liquidate a long-term asset as the need for funds arises. The majority of the secondary mortgage market activity is supported by three government-related or -controlled institutions: Fannie Mae,<sup>4</sup> Freddie Mac,<sup>5</sup> and Ginnie Mae.<sup>6</sup> These entities were created or sponsored by the federal government to encourage the financing and construction of residential housing. Fannie Mae, Freddie Mac, and Ginnie Mae have specific underwriting standards and loan-documentation requirements for mortgages purchased or guaranteed by them. Generally, financial institutions enter into either a mandatory or a standby commitment agreement with these entities wherein the financial institution agrees to sell loans according to certain delivery schedules, terms, and performance penalties.

## Commercial Real Estate Loans

As with other types of lending activities, the

4. Although Fannie Mae was originally created in 1938 as an organization within the federal government, it became a federally chartered, stockholder corporation in 1968 when some of its functions were placed under the newly created Ginnie Mae. Financial institutions can either sell mortgages directly to Fannie Mae or pool mortgages for placement in a Fannie Mae-guaranteed mortgage-backed security.

5. Freddie Mac was sponsored by the Federal Home Loan Bank Board and its members in 1970. Its primary purpose is to provide a secondary market for conventional mortgages originated by thrifts.

6. Ginnie Mae, a government agency under the Department of Housing and Urban Development (HUD), was created in 1968 when Fannie Mae became a private corporation. It has several functions to assist in government housing programs, such as managing and liquidating loans acquired by the government. In the secondary market, Ginnie Mae acts as a guarantor of mortgage-backed securities for pools of loans originated and securitized by financial institutions.

extent of commercial real estate lending activity should be contingent upon the lender's expertise and the bank's experience. In considering an application for a commercial real estate loan, a bank should understand the relationship of the actual borrower to the project being financed. The form of business ownership varies for commercial real estate projects and can affect the management, financial resources available for the completion of the project, and repayment of the loan.

Information on past and current projects constructed, rented, or managed by the potential borrower can help the bank assess the borrower's experience and the likelihood of the proposed project's success. For development and construction projects, the bank should closely review the project's feasibility study. The study should provide sensitivity and risk analyses of the potential impact of changes in key economic variables, such as interest rates, vacancy rates, or operating expenses. The bank should also conduct credit checks of the borrower and of all principals involved in the transaction to verify relationships with contractors, suppliers, and business associates.

Finally, the bank should assess the borrower's financial strength to determine if the principals of the project have the necessary working capital and financial resources to support the project until it reaches stabilization. As with any type of lending on income-producing properties,<sup>7</sup> the bank should quantify the degree of protection from the borrower's (or collateral's) cash flow, the value of the underlying collateral, and any guarantees or other collateral that may be available as a source of loan repayment.

## BANK ASSESSMENT OF REAL ESTATE COLLATERAL

Banks should obtain an appraisal or evaluation, as appropriate, for all real estate-related financial transactions before making the final credit or other decision. The Federal Reserve's appraisal regulation requires institutions to obtain appraisals when certain criteria are met. See "Real

7. Income-producing commercial properties include rental apartments, retail properties, office buildings, warehouses, and hotels.



Estate Appraisals and Evaluations” section 4140.1, for a description of the related requirements a bank must follow for real estate–related financial transactions. The appraisal section explains the standards for appraisals, indicates which transactions require an appraisal or an evaluation, states qualifications for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal approaches.

Management is responsible for reviewing the reasonableness of the appraisal’s or evaluation’s assumptions and conclusions. Also, management’s rationale for accepting and relying upon the appraisal or evaluation should be documented in writing. In assessing the underwriting risks, management should reconsider any assumptions used by an appraiser that reflect overly optimistic or pessimistic values. If management, after its review of the appraisal or evaluation, determines that there are unsubstantiated assumptions, the bank may request the appraiser or evaluator to provide a more detailed justification of the assumptions or obtain a new appraisal or evaluation.

### Single-Family Residential Loans

The assessment of a residential property’s market value is critical to the bank’s estimate of loan-to-value ratio. This assessment provides the bank with an estimate of the borrower’s equity in the property and the bank’s potential credit risk if the borrower should default on the loan. For mortgages over \$250,000, a bank is required to obtain an appraisal in conformance with the Federal Reserve’s appraisal regulation. As of January 1, 1993, the appraisal must be performed by a state-certified or -licensed appraiser, as specified in the regulation. While transactions under \$250,000 do not require an appraisal, a bank is expected to perform an appropriate evaluation of the underlying real estate collateral. Loans that are wholly or partially insured or guaranteed by a U.S. government agency or government-sponsored agency are exempt from the Federal Reserve’s appraisal regulation, so long as the loan meets the underwriting requirements of the federal insurer or guarantor. Additionally, state laws for appraisals may differ from the Federal Reserve’s requirements.

Loans qualifying for sale to any U.S. government agency or government-sponsored agency or conforming to the appraisal standards of Fannie Mae and Freddie Mac are also exempt from the Federal Reserve’s appraisal regulation. Fannie Mae and Freddie Mac jointly developed and adopted the Uniform Residential Appraisal Report (URAR) as the standard form for residential loans sold to them. As a result, a properly completed URAR form is considered the industry standard for appraising one- to four-family residential properties.

### Commercial Real Estate Loans

Due to the variety of uses and the complexity of most commercial projects, there is not a uniformly accepted format for valuing commercial properties like there is for valuing one- to four-family residential properties. A bank relies on outside appraisers, or in some instances in-house expertise, to prepare appraisals. For the most part, appraisals on commercial real estate projects are presented in a narrative format with supporting schedules. As the complexity of a commercial project increases, the detail of the appraisal report or evaluation should also increase to fully support the analysis.

When estimating the value of income-producing real estate, the appraiser generally relies to a greater degree on the income approach to valuation than on the comparable-sales approach or the cost approach. The income approach converts all expected future net operating income into present-value terms, using different analytical methods. One method, known as the direct capitalization method, estimates the present value of a property by discounting its stabilized net operating income at an appropriate capitalization rate (commonly referred to as a cap rate). Stabilized net operating income is the net cash flow derived from a property when market conditions are stable and no unusual patterns of future rents and occupancy are expected. To approximate stabilized net operating income, the appraiser or bank may need to adjust the current net operating income of a property either up or down to reflect current market conditions. The direct capitalization method is appropriate only for use in valuing stabilized properties.

Another method, known as the discounted cash-flow method, requires the discounting of expected future cash flows at an appropriate

discount rate to ascertain the net present value of a property. This method is appropriate for use in estimating the values of new properties that have not yet stabilized, or for troubled properties that are experiencing fluctuations in income.

The discount rates and cap rates, used in estimating property values, should reflect reasonable expectations about the rate of return that investors and lenders require under normal, orderly, and sustainable market conditions. The appraiser's analysis and assumptions should support the discount and cap rates used in the appraisal. The appraiser should not use exaggerated, imprudent, or unsustainably high or low discount rates, cap rates, or income projections.

In assessing the reasonableness of the facts and assumptions associated with the valuation of commercial real estate, the bank should consider—

- current and projected vacancy and absorption rates;
- lease-renewal trends and anticipated rents;
- volume and trends in past-due leases;
- the project's feasibility study and market survey to determine support for the assumptions concerning future supply-and-demand factors;
- effective rental rates or sale prices (taking into account all concessions);
- net operating income of the property as compared with budget projections; and
- discount rates and direct capitalization rates.

Because the income approach is generally relied on to a greater degree than the other methods, with specific emphasis on arriving at stabilized values, the bank must use judgment in determining the time it will take for a property to achieve stabilized occupancy and rental rates. The analysis of collateral values should not be based on a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions.

The capacity of a property to generate cash flow to service a loan is evaluated on the basis of rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy, rental rates, and net operating income should be based on an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate.

## EARLY INDICATIONS OF TROUBLED COMMERCIAL REAL ESTATE LOANS

### Market-Related

To evaluate the collectibility of their commercial real estate portfolio, banks should be alert for economic indicators of weakness in their real estate markets as well as for indicators of actual or potential problems in the individual commercial real estate projects. Available indicators useful in evaluating the condition of the local real estate market include permits for and the value of new construction, absorption rates, employment trends, vacancy rates, and tenant lease incentives. Weaknesses disclosed by these types of statistics may signify that a real estate market is experiencing difficulties that may cause cash-flow problems for individual real estate projects, declining real estate values, and ultimately, troubled real estate loans.

### Project-Related

Characteristics of potential or actual difficulties in commercial real estate projects may include—

- an excess supply of similar projects under construction in the same trade area.
- the lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- rent concessions or sales discounts, resulting in cash flow below the level projected in the original feasibility study, appraisal, or evaluation.
- concessions on finishing tenant space, moving expenses, and lease buyouts.
- slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- delinquent lease payments from major tenants.
- land values that assume future rezoning.
- tax arrearages.
- environmental hazards and liability for cleanup.

As the problems associated with a commercial real estate loan become more pronounced, the borrower/guarantor may experience a reduction in cash flow to service-related debts, which could result in delinquent interest and principal payments.

While some real estate loans become troubled because of a general downturn in the market, others become troubled because the loans were originated on an unsound or a liberal basis. Common examples of unsound loans include—

- loans with no or minimal borrower equity
- loans on speculative undeveloped property in which the borrower's only source of repayment is the sale of the property
- loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value
- additional advances to service an existing loan without evidence that the loan will be repaid in full
- loans to borrowers with no development plans or noncurrent development plans
- renewals, extensions, and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule<sup>8</sup>

## EXAMINER REVIEW OF COMMERCIAL REAL ESTATE LOANS

The focus of an examiner's review of a real estate loan is on the ability of the loan to be repaid. The principal factors that bear on this review are the income-producing potential of the underlying collateral and the borrower's willingness and ability to repay the loan from other resources, if necessary, and according to existing loan terms. In evaluating the overall risk associated with a real estate loan, examiners should consider a number of factors, including

the borrower's character, overall financial condition and resources, and payment history; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.<sup>9</sup> As the borrower's and guarantor's ability to repay a troubled real estate loan decreases, the importance of the collateral value of the loan increases commensurately.

### Examiner Review of the Real Estate Collateral

An examiner's analysis of the collateral value is based on the bank's most recent appraisal or evaluation and includes a review of the major facts, assumptions, and approaches used by the appraiser or person performing the evaluation (including any comments made by management relative to the reasonableness of the appraisal or evaluation assumptions and conclusions). While the examiner may make adjustments to the assessment of value, these adjustments should be made solely for purposes of an examiner's analysis and assessment of credit quality and should not involve an adjustment to the actual appraisal or evaluation.

Furthermore, examiners should not make adjustments to appraisal or evaluation assumptions for credit-analysis purposes based on worst-case scenarios that are unlikely to occur. For example, an examiner should not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today's market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit-analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

Assumptions, when recently made by qualified appraisers or persons performing the evalu-

8. As discussed more fully in the section on classification guidelines, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. As consistent with sound banking practices, institutions should work appropriately and constructively with borrowers who may be experiencing temporary difficulties.

9. The primary basis for the review and classification of the loan should be the original source of repayment and the borrower's intent and ability to fulfill the obligation without relying on third-party guarantees. However, the examiner should also consider the support provided by any guarantees when determining the appropriate classification treatment for a troubled loan. The treatment of guarantees in the classification process is discussed in "Classification of Credits," section 2060.1.



ation and when consistent with the discussion above, should be given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and cap rates used in appraisals or evaluations, that differ only in a limited way from norms that would generally be associated with the property under review. However, the estimated value of the underlying collateral may be adjusted for credit-analysis purposes when the examiner can establish that underlying facts or assumptions are inappropriate and can support alternative assumptions.

## CLASSIFICATION GUIDELINES

As with other types of loans, real estate loans that are adequately protected by the current sound worth and debt-service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. The examiner should focus on the ability of the borrower, guarantor, or the collateral to provide the necessary cash flow to adequately service the loan. The loan's record of performance is also important and must be taken into consideration. As a general principle, a performing real estate loan should not be automatically classified or charged off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. Conversely, the fact that the underlying collateral value equals or exceeds the current loan balance, or that the loan is performing, does not preclude the loan from classification if well-defined weaknesses jeopardize the repayment ability of the borrower, such as the lack of credible financial support for full repayment from reliable sources.<sup>10</sup>

Similarly, loans to sound borrowers that are refinanced or renewed according to prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be categorized as special mention unless potential weaknesses exist or should not be classified unless well-

defined weaknesses exist that jeopardize repayment. An institution should not be criticized for working with borrowers whose loans are classified or categorized as special mention as long as the institution has a well-conceived and effective workout plan for such borrowers, along with effective internal controls to manage the level of these loans.

In evaluating real estate credits for special-mention categorization or classification, examiners should apply the standard definitions as set forth in "Classification of Credits," section 2060.1. In assessing credit quality, examiners should consider all important information regarding repayment prospects, including information on the borrower's creditworthiness, the value of and cash flow provided by all collateral supporting the loan, and any support provided by financially responsible guarantors.

These guidelines apply to individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits in the same industry that are not affected by the problems of the troubled sectors.

### Troubled Project-Dependent Commercial Real Estate Loans

The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment. As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can be clearly identified as uncollectible, should be classified loss. The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than substandard. The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified doubtful

10. Another issue that arises in the review of a commercial real estate loan is its accrual or nonaccrual treatment for reporting purposes. The federal banking agencies, under the auspices of the FFIEC, have provided guidance on nonaccrual status in the instructions for the Reports of Condition and Income (call reports) and in related supervisory guidance of the agencies. This guidance is summarized in "Loan Portfolio Management," section 2040.1.

when the potential for full loss may be mitigated by the outcome of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined. If warranted by the underlying circumstances, an examiner may use a doubtful classification on the entire loan balance. However, such a classification should occur infrequently.

### Partially Charged-Off Loans

An evaluation based upon consideration of all relevant factors may indicate that a credit has well-defined weaknesses that jeopardize collection in full, although a portion of the loan may be reasonably assured of collection. When a charge-off has been taken in an amount sufficient to ensure that the remaining recorded balance of the loan (1) is being serviced (based upon reliable sources) and (2) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than substandard.

A more severe classification than substandard for the remaining recorded balance would be appropriate, however, if the loss exposure cannot be reasonably determined—for example, when significant risk exposures are perceived, such as in the case of bankruptcy or loans collateralized by properties subject to environmental hazards. In addition, classifying the remaining recorded balance more severely than substandard would be appropriate when sources of repayment are considered unreliable.

### Formally Restructured Loans

The classification treatment previously discussed for a partially charged-off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate if, after the restructuring, well-defined weak-

nesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms.<sup>11</sup> Troubled commercial real estate loans whose terms have been restructured should be identified in the institution's internal credit-review system and closely monitored by management.

### Home Equity Loans

Home equity loans (HELs) are defined as loans that are usually collateralized by a second mortgage or deed of trust on the borrower's principal residence or second residence; however, the collateral may be a first mortgage or deed of trust. The borrower's equity in the residence, pledged as collateral, provides protection for the loan and determines the maximum amount of credit that may be advanced. Traditionally, HELs were used to fund home improvements or to consolidate debt, and they were usually amortized without a revolving feature. Because of these characteristics, home equity loans were commonly maintained and administered in a bank's consumer or installment loan department and were monitored based on delinquency status. However, since enactment of the Tax Reform Act of 1986, which allows the deduction of home equity loan interest on debt of up to \$100,000, the popularity and usage of HELs have expanded considerably. The proceeds of home equity loans are now used for increasingly diverse purposes, such as to make consumer purchases or personal investments, to provide working capital for small businesses, and to supplement personal income.

The structure and repayment terms of home equity loans have become more varied. Amortization periods may be as long as 15 years, with possible balloon maturities of three to five years. In some instances, the payment requirement is only interest due for an initial period. Revolving lines of credit have also gained popularity as a way to accommodate the many different uses of loan proceeds. Lines of credit to individuals with high incomes or high net worths may substantially exceed \$100,000. These loans are often housed in the bank's private-banking

11. An example of a restructured commercial real estate loan that does not have reasonable modified terms would be a cash-flow mortgage, which requires interest payments only when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

division or within the commercial loan portfolio, rather than in the consumer loan department.

In addition to the increasingly varied purposes of HELs, there has also been an upsurge in loans in which the combined first and second mortgages result in very high LTV ratios. To remain competitive with other residential lenders, some banks have relaxed their underwriting standards by permitting higher LTV ratios. In addition, some banks may have offset declines in residential mortgage refinancing during periods of higher interest rates by competing more aggressively for home equity loan business. Consumer demand for HELs may also increase during periods of higher interest rates because they provide an alternative source of financing for consumer purchases.

Examiners must ensure that a bank's policies for originating and acquiring HELs comply with the real estate lending standards and guidelines stipulated in the Board's Regulation H, subpart E. (See Regulation H, subpart E, 12 CFR 208.50–51.) While the guidelines permit banks to make residential real estate loans with LTV ratios in excess of 90 percent without the appropriate credit enhancements, these loans are treated as exceptions to the guidelines and are subject to the aggregate limitation of 100 percent of the bank's total capital.

For all types of lending, banks should have strong underwriting standards for HELs. In assessing these standards, the examiner should determine whether the bank primarily emphasizes the borrower's ability and willingness to repay the loan from income or cash flow versus the amount of equity in the real estate. Extended repayment terms and liberal loan structures can increase the risk of default on HELs. Normally, longer repayment terms increase the likelihood of events that could jeopardize the borrower's ability to repay, for example, the loss of a job, a change in marital status, a prolonged spike in prevailing interest rates, or a deflationary economic environment. Additionally, the examiner should review the bank's policy (or practice) for obtaining appraisals or evaluations to determine the lendable equity in the borrower's residence. The examiner should determine that the bank has not relaxed its appraisal and evaluation requirements to accommodate the growth of its HEL portfolio.

Economic periods of increasing unemployment, rising interest rates, or other recessionary factors can negatively affect the repayment ability of borrowers and erode the value and mar-

ketability of residential real estate. Moreover, most HELs are collateralized by junior lien positions. Therefore, if the bank forecloses, it must pay off or service the senior mortgage lender, further increasing its exposure. Foreclosure proceedings may entail lengthy and costly litigation, and real estate law commonly protects the home owner.

Examiners should ensure that banks have proper controls to manage HEL exposure, particularly those banks that have a high concentration of home equity loans with excessively high combined LTV ratios. (See the following subsection for interagency guidance on credit-risk management in home equity lending.) Banks with concentrations that lack proper controls and monitoring procedures should be criticized for these credit deficiencies. If the examiner judges the deficiencies to be severe, the bank should be cited for unsafe and unsound banking practices.

### Interagency Credit-Risk Management Guidance for Home Equity Lending

The Federal Reserve and the other federal financial institutions regulatory agencies<sup>12</sup> collectively issued this interagency guidance on May 16, 2005. The guidance is intended to promote sound credit-risk management practices at financial institutions that have home equity lending programs, including open-end home equity lines of credit (HELOCs) and closed-end home equity loans (HELs). Home equity lending can be an attractive product for many homeowners and lenders. The quality of these portfolios, however, is subject to increased risk if interest rates rise and home values decline. Sound underwriting practices and effective risk-management systems are essential to mitigate this risk. Therefore, financial institutions' credit-risk management practices for home equity lending need to keep pace with any rapid growth in home equity lending and should emphasize compliance with sound underwriting standards and practices.

12. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration. Also, the interagency guidance frequently uses the term *financial institutions*. As used in this section, *financial institutions* means commercial banks and any of their various credit-extending nonbanking subsidiaries.

The risk factors listed below, combined with an inherent vulnerability to rising interest rates, suggest that financial institutions need to fully recognize the risk embedded in their home equity portfolios. Following are the specific product, risk-management, and underwriting risk factors and trends that deserve scrutiny:

- interest-only features that require no amortization of principal for a protracted period
- limited or no documentation of a borrower's assets, employment, and income (known as "low doc" or "no doc" lending)
- higher loan-to-value (LTV) and debt-to-income (DTI) ratios
- lower credit-risk scores for underwriting home equity loans
- greater use of automated valuation models (AVMs) and other collateral-evaluation tools for the development of appraisals and evaluations
- an increase in the number of transactions generated through a loan broker or other third party

Home equity lending can be conducted in a safe and sound manner if pursued with the appropriate risk-management structure, including adequate allowances for loan and lease losses and appropriate capital levels. Sound practices call for fully articulated policies that address marketing, underwriting standards, collateral-valuation management, individual-account and portfolio management, and servicing.

Financial institutions should ensure that risk-management practices keep pace with the growth and changing risk profile of home equity portfolios. Management should actively assess a portfolio's vulnerability to changes in consumers' ability to pay and the potential for declines in home values. Active portfolio management is especially important for financial institutions that project or have already experienced significant growth or concentrations, particularly in higher-risk products such as high-LTV, "low doc" or "no doc," interest-only, or third-party-generated loans. (See SR-05-11.)

## Credit-Risk Management Systems

### *Product Development and Marketing*

In the development of any new product offering, product change, or marketing initiative, manage-

ment should have a review and approval process that is sufficiently broad to ensure compliance with the financial institution's internal policies and applicable laws and regulations<sup>13</sup> and to evaluate the credit, interest-rate, operational, compliance, reputation, and legal risks. In particular, risk-management personnel should be involved in product development, including an evaluation of the targeted population and the product(s) being offered. For example, material changes in the targeted market, origination source, or pricing could have a significant impact on credit quality and should receive senior management approval.

When HELOCs or HELs are marketed or closed by a third party, financial institutions should have standards that provide assurance that the third party also complies with applicable laws and regulations, including those on marketing materials, loan documentation, and closing procedures. (For further details on agent relationships, see "Third-Party Originations.") Finally, management should have appropriate monitoring tools and management information systems (MIS) to measure the performance of various marketing initiatives, including offers to increase a line, extend the interest-only period, or adjust the interest rate or term.

### *Origination and Underwriting*

All relevant risk factors should be considered when establishing product offerings and underwriting guidelines. Generally, these factors should include a borrower's income and debt levels, credit score (if obtained), and credit history, as well as the loan size, collateral value (including valuation methodology), lien position, and property type and location.

Consistent with the Federal Reserve's regulations on real estate lending standards,<sup>14</sup> prudently underwritten home equity loans should include an evaluation of a borrower's capacity

13. Applicable laws include the Federal Trade Commission Act; the Equal Credit Opportunity Act (ECOA); the Truth in Lending Act (TILA), including the Home Ownership and Equity Protection Act (HOEPA); the Fair Housing Act; the Real Estate Settlement Procedures Act (RESPA); and the Home Mortgage Disclosure Act (HMDA), as well as applicable state consumer protection laws.

14. On December 23, 1992, the Federal Reserve announced the adoption of uniform rules on real estate lending standards and issued the Interagency Guidelines for Real Estate Lending Policies. See 12 CFR 208.51 and 12 CFR 208, appendix C.

to adequately service the debt.<sup>15</sup> Given the home equity products' long-term nature and the large credit amount typically extended to a consumer, an evaluation of repayment capacity should consider a borrower's income and debt levels and not just a credit score.<sup>16</sup> Credit scores are based upon a borrower's historical financial performance. While past performance is a good indicator of future performance, a significant change in a borrower's income or debt levels can adversely alter the borrower's ability to pay. How much verification these underwriting factors require will depend upon the individual loan's credit risk.

HELOCs generally do not have interest-rate caps that limit rate increases.<sup>17</sup> Rising interest rates could subject a borrower to significant payment increases, particularly in a low-interest-rate environment. Therefore, underwriting standards for interest-only and variable-rate HELOCs should include an assessment of the borrower's ability to amortize the fully drawn line over the loan term and to absorb potential increases in interest rates.

### *Third-Party Originations*

Financial institutions often use third parties, such as mortgage brokers or correspondents, to originate loans. When doing so, institutions should have strong control systems to ensure the quality of originations and compliance with all applicable laws and regulations, and to help prevent fraud.

*Brokers* are firms or individuals, acting on behalf of either the financial institution or the borrower, who match the borrower's needs with institutions' mortgage-origination programs. Brokers take applications from consumers. Although they sometimes process the application and underwrite the loan to qualify the application for a particular lender, they generally do not use their own funds to close loans. Whether brokers are allowed to process and

perform any underwriting will depend on the relationship between the financial institution and the broker. For control purposes, the financial institution should retain appropriate oversight of all critical loan-processing activities, such as verification of income and employment and independence in the appraisal and evaluation function.

*Correspondents* are financial companies that usually close and fund loans in their own name and subsequently sell them to a lender. Financial institutions commonly obtain loans through correspondents and, in some cases, delegate the underwriting function to the correspondent. In delegated underwriting relationships, a financial institution grants approval to a correspondent financial company to process, underwrite, and close loans according to the delegator's processing and underwriting requirements and is committed to purchase those loans. The delegating financial institution should have systems and controls to provide assurance that the correspondent is appropriately managed, is financially sound, and provides mortgages that meet the financial institution's prescribed underwriting guidelines and that comply with applicable consumer protection laws and regulations. A quality-control unit or function in the delegating financial institution should closely monitor the quality of loans that the correspondent underwrites. Monitoring activities should include post-purchase underwriting reviews and ongoing portfolio-performance-management activities.

Both brokers and correspondents are compensated based upon mortgage-origination volume and, accordingly, have an incentive to produce and close as many loans as possible. Therefore, financial institutions should perform comprehensive due diligence on third-party originators prior to entering a relationship. In addition, once a relationship is established, the financial institution should have adequate audit procedures and controls to verify that the third parties are not being paid to generate incomplete or fraudulent mortgage applications or are not otherwise receiving referral or unearned income or fees contrary to RESPA prohibitions.<sup>18</sup> Monitoring

15. See also section 226.34(a)(4) of Regulation Z, Truth in Lending (12 CFR 226.34(a)(4)).

16. The Interagency Guidelines Establishing Standards for Safety and Soundness also call for documenting the source of repayment and assessing the ability of the borrower to repay the debt in a timely manner. See 12 CFR 208, appendix D-1.

17. While there may be periodic rate increases, the lender must state in the consumer credit contract the maximum interest rate that may be imposed during the term of the obligation. See 12 CFR 226.30(b).

18. In addition, a financial institution that purchases loans subject to TILA's rules for HELs with high rates or high closing costs (loans covered by HOEPA) can incur assignee liability unless the financial institution can reasonably show that it could not determine the transaction was a loan covered by HOEPA. Also, the nature of its relationship with brokers and correspondents may have implications for liability under

the quality of loans by origination source, and uncovering such problems as early payment defaults and incomplete packages, enables management to know if third-party originators are producing quality loans. If ongoing credit or documentation problems are discovered, the financial institution should take appropriate action against the third party, which could include terminating its relationship with the third party.

### *Collateral-Valuation Management*

Competition, cost pressures, and advancements in technology have prompted financial institutions to streamline their appraisal and evaluation processes. These changes, coupled with financial institutions underwriting to higher LTVs, have heightened the importance of strong collateral-valuation management policies, procedures, and processes.

Financial institutions should have appropriate collateral-valuation policies and procedures that ensure compliance with the Federal Reserve's appraisal regulations<sup>19</sup> and the Interagency Appraisal and Evaluation Guidelines (the guidelines).<sup>20</sup> In addition, the financial institution should—

- establish criteria for determining the appropriate valuation methodology for a particular transaction, based on the risk in the transaction and loan portfolio (For example, higher-risk transactions or nonhomogeneous property types should be supported by more-thorough valuations. The financial institution should also set criteria for determining the extent to which an inspection of the collateral is necessary.)
- ensure that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation
- implement policies and controls to preclude “value shopping” (Use of several valuation tools may return different values for the same property. These differences can result in systematic overvaluation of properties if the valuation choice becomes driven by the highest property value. If several different valuation tools or AVMs are used for the same property,

the financial institution should adhere to a policy for selecting the most reliable method, rather than the highest value.)

- require sufficient documentation to support the collateral valuation in the appraisal or evaluation

### *AVMs*

When AVMs are used to support evaluations or appraisals, the financial institution should validate the models on a periodic basis to mitigate the potential valuation uncertainty in the model. This validation work should be in conformance with SR-11-7. In particular, the financial institution should document the validation's analysis, assumptions, and conclusions. The validation process includes back-testing a representative sample of the valuations against market data on actual sales (where sufficient information is available). The validation process should cover properties representative of the geographic area and property type for which the tool is used.

Many AVM vendors, when providing a value, will also provide a “confidence score,” which usually relates to the accuracy of the value provided. Confidence scores, however, come in many different formats and are calculated based on differing scoring systems. Financial institutions that use AVMs should have an understanding of how the model works as well as what the confidence scores mean. Institutions should also establish the confidence levels that are appropriate for the risk in a given transaction or group of transactions.

When tax-assessment valuations are used as a basis for the collateral valuation, the financial institution should be able to demonstrate and document the correlation between the assessment value of the taxing authority and the property's market value as part of the validation process.

### *Account Management*

Since HELOCs often have long-term, interest-only payment features, financial institutions should have risk-management techniques that identify higher-risk accounts and adverse changes in account risk profiles, thereby enabling management to implement timely preventive action (e.g., freezing or reducing lines). Further, a financial institution should have risk-management

ECOA, and for reporting responsibilities under HMDA.

19. 12 CFR 208, subpart E, and 12 CFR 225, subpart G.

20. See SR-10-16, December 2, 2010, and its attachment.

procedures to evaluate and approve additional credit on an existing line or extending the interest-only period. Account-management practices should be appropriate for the size of the portfolio and the risks associated with the types of home equity lending.

Effective account-management practices for large portfolios or portfolios with high-risk characteristics include—

- periodically refreshing credit-risk scores on all customers;
- using behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts;
- periodically assessing utilization rates;
- periodically assessing payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the line to keep payments current;
- monitoring home values by geographic area; and
- obtaining updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral.

The frequency of these actions should be commensurate with the risk in the portfolio. Financial institutions should conduct annual credit reviews of HELOC accounts to determine whether the line of credit should be continued, based on the borrower's current financial condition.<sup>21</sup>

When appropriate, financial institutions should refuse to extend additional credit or reduce the credit limit of a HELOC, bearing in mind that under Regulation Z such steps can be taken only in limited circumstances. These include, for example, when the value of the collateral declines significantly below the appraised value for purposes of the HELOC, default of a material obligation under the loan agreement, or deterioration in the borrower's financial circum-

stances.<sup>22</sup> In order to freeze or reduce credit lines due to deterioration in a borrower's financial circumstances, two conditions must be met: (1) there must be a "material" change in the borrower's financial circumstances and (2) as a result of this change, the financial institution must have a reasonable belief that the borrower will be unable to fulfill the plan's payment obligations.

Account-management practices that do not adequately control authorizations and provide for timely repayment of over-limit amounts may significantly increase a portfolio's credit risk. Authorizations of over-limit home equity lines of credit should be restricted and subject to appropriate policies and controls. A financial institution's practices should require over-limit borrowers to repay in a timely manner the amount that exceeds established credit limits. Management information systems should be sufficient to enable management to identify, measure, monitor, and control the unique risks associated with over-limit accounts.

### *Portfolio Management*

Financial institutions should implement an effective portfolio credit-risk management process for their home equity portfolios that includes the following.

*Policies.* The Federal Reserve's real estate lending standards regulations require that a financial institution's real estate lending policies be consistent with safe and sound banking practices and that the financial institution's board of directors review and approve these policies at least annually. Before implementing any changes to policies or underwriting standards, management should assess the potential effect on the financial institution's overall risk profile, which would include the effect on concentrations, profitability, and delinquency and loss rates. The accuracy of these estimates should be tested by comparing them with actual experience.

*Portfolio objectives and risk diversification.* Effective portfolio management should clearly communicate portfolio objectives such as growth targets, utilization, rate-of-return hurdles, and

21. Under the Federal Reserve's risk-based capital guidelines, an unused HELOC commitment with an original maturity of one year or more may be allocated a zero percent conversion factor if the institution conducts at least an annual credit review and is able to unconditionally cancel the commitment (i.e., prohibit additional extensions of credit, reduce the credit line, and terminate the line) to the full extent permitted by relevant federal law. See 12 CFR 208, appendix A, III.D.4.

22. Regulation Z does not permit these actions to be taken in circumstances other than those specified in the regulation. See 12 CFR 226.5b(f)(3)(vi)(A)–(F).

default and loss expectations. For financial institutions with significant concentrations of HELs or HELOCs, limits should be established and monitored for key portfolio segments, such as geographic area, loan type, and higher-risk products. When appropriate, consideration should be given to the use of risk mitigants, such as private mortgage insurance, pool insurance, or securitization. As the portfolio approaches concentration limits, the financial institution should analyze the situation sufficiently to enable the financial institution's board of directors and senior management to make a well-informed decision to either raise concentration limits or pursue a different course of action.

Effective portfolio management requires an understanding of the various risk characteristics of the home equity portfolio. To gain this understanding, a financial institution should analyze the portfolio by segment, using criteria such as product type, credit-risk score, DTI, LTV, property type, geographic area, collateral-valuation method, lien position, size of credit relative to prior liens, and documentation type (such as "no doc" or "low doc").

*Management information systems.* By maintaining adequate credit MIS, a financial institution can segment loan portfolios and accurately assess key risk characteristics. The MIS should also provide management with sufficient information to identify, monitor, measure, and control home equity concentrations. Financial institutions should periodically assess the adequacy of their MIS in light of growth and changes in their appetite for risk. For institutions with significant concentrations of HELs or HELOCs, MIS should include, at a minimum, reports and analysis of the following:

- production and portfolio trends by product, loan structure, originator channel, credit score, LTV, DTI, lien position, documentation type, market, and property type
- delinquency and loss-distribution trends by product and originator channel with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, DTI)
- vintage tracking
- the performance of third-party originators (brokers and correspondents)
- market trends by geographic area and property type to identify areas of rapidly appreciating or depreciating housing values

*Policy- and underwriting-exception systems.* Financial institutions should have a process for identifying, approving, tracking, and analyzing underwriting exceptions. Reporting systems that capture and track information on exceptions, both by transaction and by relevant portfolio segments, facilitate the management of a portfolio's credit risk. The aggregate data is useful to management in assessing portfolio risk profiles and monitoring the level of adherence to policy and underwriting standards by various origination channels. Analysis of the information may also be helpful in identifying correlations between certain types of exceptions and delinquencies and losses.

*High-LTV monitoring.* To clarify the real estate lending standards regulations and interagency guidelines, the agencies issued Guidance on High Loan-To-Value LTV Residential Real Estate Lending (the HLTV guidance) in October 1999. The HLTV guidance clarified the Interagency Real Estate Lending Guidelines and the supervisory loan-to-value limits for loans on one- to four-family residential properties. Financial institutions are expected to ensure compliance with the supervisory loan-to-value limits of the Interagency Real Estate Lending Guidelines. The HLTV guidance places emphasis on certain controls that financial institutions should have in place when engaging in HLTV lending. Financial institutions should accurately track the volume of HLTV loans, including HLTV home equity and residential mortgages, and report the aggregate of such loans to the financial institution's board of directors. Specifically, financial institutions are reminded that:

- Loans in excess of the supervisory LTV limits should be identified in the financial institution's records. The aggregate of high-LTV one- to four-family residential loans should not exceed 100 percent of the financial institution's total capital.<sup>23</sup> Within that limit, high-

23. For purposes of the Interagency Real Estate Lending Standards Guidelines, high-LTV one- to four-family residential property loans include (1) a loan for raw land zoned for one- to four-family residential use with an LTV ratio greater than 65 percent; (2) a residential land development loan or improved lot loan with an LTV greater than 75 percent; (3) a residential construction loan with an LTV ratio greater than 85 percent; (4) a loan on non-owner occupied one- to four-family residential property with an LTV greater than 85 percent; and (5) a permanent mortgage or home equity loan on an owner-occupied residential property with an LTV equal to or exceeding 90 percent without mortgage insurance.



LTV loans for properties other than one- to four-family residential properties should not exceed 30 percent of capital.

- In calculating the LTV and determining compliance with the supervisory LTVs, the financial institution should consider all senior liens. All loans secured by the property and held by the financial institution are reported as an exception if the combined LTV of a loan and all senior liens on an owner-occupied one- to four-family residential property equals or exceeds 90 percent and if there is no additional credit enhancement in the form of either mortgage insurance or readily marketable collateral.
- For the LTV calculation, the loan amount is the legally binding commitment (that is, the entire amount that the financial institution is legally committed to lend over the life of the loan).
- All real estate secured loans in excess of supervisory LTV limits should be aggregated and included in a quarterly report for the financial institution's board of directors.

Certain insurance products have been developed to help financial institutions mitigate the credit risks of HLTV residential loans. Insurance policies that cover a "pool" of loans can be an efficient and effective credit-risk management tool. But if a policy has a coverage limit, the coverage may be exhausted before all loans in the pool mature or pay off. The Federal Reserve will consider pool insurance to be a sufficient credit enhancement to remove the HLTV designation in the following circumstances: (1) the policy is issued by an acceptable mortgage insurance company, (2) it reduces the LTV for each loan to less than 90 percent, and (3) it is effective over the life of each loan in the pool.

*Stress testing for portfolios.* Financial institutions with home equity concentrations as well as higher-risk portfolios are encouraged to perform sensitivity analyses on key portfolio segments. This type of analysis identifies possible events that could increase risk within a portfolio segment or for the portfolio as a whole. Institutions should consider stress tests that incorporate interest-rate increases and declines in home values. Since these events often occur simultaneously, the testing should be performed for these events together. Institutions should also

readily marketable collateral, or other acceptable collateral.

periodically analyze markets in key geographic areas, including identified "soft" markets. Management should consider developing contingency strategies for scenarios and outcomes that extend credit risk beyond internally established risk tolerances. These contingency plans might include increased monitoring, tightening underwriting, limiting growth, and selling loans or portfolio segments.

### *Operations, Servicing, and Collections*

Effective procedures and controls should be maintained for such support functions as perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes. Credit-risk management should oversee these support functions to ensure that operational risks are properly controlled.

*Lien recording.* Financial institutions should take appropriate measures to safeguard their lien position. They should verify the amount and priority of any senior liens prior to closing the loan. This information is necessary to determine the loan's LTV ratio and to assess the credit support of the collateral. Senior liens include first mortgages, outstanding liens for unpaid taxes, outstanding mechanic's liens, and recorded judgments on the borrower.

*Problem-loan workouts and loss-mitigation strategies.* Financial institutions should have established policies and procedures for problem-loan workouts and loss-mitigation strategies. Policies should be in accordance with the requirements of the FFIEC's Uniform Retail Credit Classification and Account Management Policy, issued June 2000 (see SR-00-8 and the appendix to section 2130.1) and should, at a minimum, address the following:

- circumstances and qualifying requirements for various workout programs including extensions, re-ages, modifications, and re-writes (Qualifying criteria should include an analysis of a borrower's financial capacity to service the debt under the new terms.)
- circumstances and qualifying criteria for loss-mitigating strategies, including foreclosure
- appropriate MIS to track and monitor the effectiveness of workout programs, including tracking the performance of all categories of

workout loans (For large portfolios, vintage delinquency and loss tracking also should be included.)

While financial institutions are encouraged to work with borrowers on a case-by-case basis, a financial institution should *not* use workout strategies to defer losses. Financial institutions should ensure that credits in workout programs are evaluated separately for the allowance for loan and lease losses (ALLL), because such credits tend to have higher loss rates than other portfolio segments.

### *Secondary-Market Activities*

More financial institutions are issuing HELOC mortgage-backed securities (i.e., securitizing HELOCs). Although such secondary-market activities can enhance credit availability and a financial institution's profitability, they also pose certain risk-management challenges. An institution's risk-management systems should address the risks of HELOC securitizations.<sup>24</sup>

### *Portfolio Classifications, Allowance for Loan and Lease Losses, and Capital*

The FFIEC's Uniform Retail Credit Classification and Account Management Policy governs the classification of consumer loans and establishes general classification thresholds that are based on delinquency. Financial institutions and the Federal Reserve's examiners have the discretion to classify entire retail portfolios, or segments thereof, when underwriting weaknesses or delinquencies are pervasive and present an excessive level of credit risk. Portfolios of high-LTV loans to borrowers who exhibit inadequate capacity to repay the debt within a reasonable time may be subject to classification.

Financial institutions should establish appropriate ALLL and hold capital commensurate with the riskiness of their portfolios. In determining the ALLL adequacy, a financial institution should consider how the interest-only and draw features of HELOCs during the lines'

24. See SR-02-16, "Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations," (see also section 3020.1) and the risk management and capital adequacy of exposures arising from secondary-market credit activities discussion in SR-97-21.

revolving period could affect the loss curves for its HELOC portfolio. Those institutions engaging in programmatic subprime home equity lending or institutions that have higher-risk products are expected to recognize the elevated risk of the activity when assessing capital and ALLL adequacy.<sup>25</sup>

## ALLOWANCE FOR LOAN AND LEASE LOSSES

A bank bases the adequacy of its allowance for loan and lease losses (ALLL), including amounts resulting from an analysis of the real estate portfolio, on a careful, well-documented, and consistently applied analysis of its loan and lease portfolio.<sup>26</sup> Guidance related to the ALLL is primarily addressed in section 2070.1. The following discussion summarizes general principles for assessing the adequacy of the ALLL.

Examiners should evaluate the methodology, documentation, and process that management has followed in arriving at an overall estimate of the ALLL to ensure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the examiner should review the reasonableness of management's overall estimate of the ALLL, as well as the range of possible credit losses, by taking into account these factors. The examiner's analysis should also consider the quality of the bank's systems and management's ability to identify, monitor, and address asset-quality problems.

As discussed in the earlier subsection on classification guidelines, examiners should consider the value of the collateral when reviewing and classifying a loan. For a performing commercial real estate loan, however, the supervisory policy does not require automatic increases to

25. Section 2133.1 incorporates the January 2001 Interagency Expanded Guidance for Subprime Lending Programs. That guidance sets forth the supervisory expectations regarding risk-management processes, the ALLL, and capital adequacy for institutions engaging in subprime-lending programs.

26. The estimation process described in this section permits a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.

the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

In assessing the ALLL during examinations, it is important that the examiner recognize that management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan-administration and collection procedures and effective internal systems and controls, the estimation of anticipated losses may not be precise because of the wide range of factors that must be considered. Furthermore, the ability to estimate anticipated losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. The examiner should give considerable weight to management's estimates in assessing the adequacy of the ALLL when management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems and (2) analyzed all significant factors affecting the collectibility of the portfolio.

## REGULATORY COMPLIANCE

Banks are expected to comply with laws, regulations, and Federal Reserve policy in all aspects of their real estate lending programs. Moreover, banks should establish adequate internal controls to detect deficiencies or exceptions to their lending policy that result in unsafe and unsound lending practices. In regard to lending limits, the examiner should review the bank's lending practices in accordance with the applicable state laws in the following areas, which prescribe limits on aggregate advances to a single borrower and related borrowers:

*Transactions with affiliates.* All transactions with affiliates should be on terms and conditions that are consistent with safe and sound banking practices. The bank is expected to comply with the limits and collateral requirements of sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 371c-1) and Regulation W (12 CFR 223).

*Tie-in provisions.* Section 106 of the Bank Holding Company Act Amendments of 1970

states that a bank is prohibited from fixing or varying the consideration for extending credit, leasing or selling property of any kind, or furnishing any product or service on the condition or requirement that a customer—

- obtain additional credit, property, or service from the bank, other than a loan, discount, deposit, or trust service (a “traditional bank product”);
- obtain additional credit, property, or service from the bank's parent holding company or the parent's other subsidiaries;
- provide additional credit, property, or service to the bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;
- provide additional credit, property, or service to the bank's parent holding company or any of the parent's other subsidiaries; or
- not obtain other credit, property, or service from the competitors of the bank, the bank's parent holding company, or the parent's other subsidiaries, except that the lending bank may impose conditions and requirements in a credit transaction to ensure the soundness of the credit.

See the statutory exceptions in section 106(b) of the Bank Holding Company Act Amendments and the exceptions in the Federal Reserve's Regulation Y (12 CFR 225.7).

*Insider lending activities.* Loans to insiders should not contain more-favorable terms than those afforded to other borrowers nor should these loans pose a more-than-normal risk of repayment. The bank is expected to maintain adequate loan documentation of insider loans showing that proper approval for the loan was obtained. Such loans should comply with the Federal Reserve's Regulation O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks (12 CFR 215, subpart A).

*Loans to executives, officers, directors, and principal shareholders of correspondent banks.* There should be no preferential treatment on loans to insiders of correspondent banks nor should there be the appearance of a conflict of interest. The bank should comply with title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA)

(12 USC 1972(2)). (See also 12 CFR 215, subpart B.)

*Appraisals and evaluations.* Banks should obtain an appraisal or evaluation for all real estate-related financial transactions before making the final credit decision in conformance with title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (12 USC 3310, 3331–3351) and the Federal Reserve’s Regulation H, Membership of State Banking Institutions in the Federal Reserve System (12 CFR 208), as set forth in subpart G of Regulation Y (12 CFR 225). The Federal Reserve’s appraisal and evalu-

ation requirements are separately discussed in section 4140.1, “Real Estate Appraisals and Evaluations.”

*Consumer compliance.* The bank’s residential lending program should ensure that the loan applicant is adequately informed of the annual interest rate, finance charges, amount financed, total payments, and repayment schedule as mandated in the Federal Reserve’s Regulation Z, Truth in Lending (12 CFR 226). The bank’s process for taking, evaluating, and accepting or rejecting a credit application is subject to the Federal Reserve’s Regulation B, Equal Credit Opportunity (12 CFR 202).

# Real Estate Loans

## Examination Objectives

Effective date November 2005

## Section 2090.2

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1. To determine if policies, practices, procedures, and internal controls for real estate loans are adequate to identify and manage the risks the bank is exposed to.
  2. To ascertain if the institution has implemented risk-management programs that identify, measure, monitor, and control the inherent risks involved in real estate lending.
  3. To determine if bank officers and staff are operating in conformance with the bank's established guidelines.
  4. To evaluate the portfolio for collateral sufficiency, performance, credit quality, and collectibility.
  5. To determine compliance with applicable laws and regulations.
  6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.
- and regulations that are applicable to the organization.
  3. To determine if the financial institution has given full recognition to the risks embedded in its home equity lending.
  4. To determine whether the financial institution's risk-management practices have kept pace with the growth and changing risk profile of its home equity portfolios and whether underwriting standards have eased.
  5. To determine whether the financial institution's loan policy—
    - a. ensures prudent underwriting standards for home equity lending, including standards to ensure that a thorough evaluation of a borrower's capacity to service the debt is conducted (that is, the institution is not relying solely on the borrower's credit score);
    - b. provides risk-management safeguards for potential declines in home values;
    - c. ensures that the standards for interest-only and variable-rate home equity lines of credit (HELOCs) include an assessment of a borrower's ability to (1) amortize the fully drawn line of credit over the loan term and (2) absorb potential increases in interest rates; and
    - d. provides appropriate collateral-valuation policies and procedures and provides for the use and validation of automated valuation models.

### Home Equity Lending

1. To determine if the financial institution has an appropriate review and approval process for new product offerings, product changes, and marketing initiatives.
2. To ascertain whether the financial institution has appropriate control procedures for third parties that generate loans on its behalf and if the control procedures comply with the laws

# Real Estate Loans

## Examination Procedures

Effective date November 2005

## Section 2090.3

1. Determine the scope of the examination, based on the evaluation of internal controls and the work performed by internal or external auditors.
2. Review the board of directors minutes to ensure that real estate loan policies are reviewed and approved at least annually.
3. Test real estate loans for compliance with policies, practices, and procedures by performing the remaining examination procedures in this section. Obtain a listing of any deficiencies noted in the latest internal or external audit report, and determine if appropriate corrections have been made. Additionally, obtain a list of personnel changes. Determine if these changes are significant enough to influence the scope of the examination.
4. Obtain a trial balance and delinquency listing for all real estate loans.
  - a. Reconcile the real estate department's trial balance totals to the bank's general ledger accounts.
  - b. Review reconciling items for reasonableness.
  - c. Obtain information (for example, paid-to dates, last date paid, and date of nonaccrual status) on past-due loans and loans on nonaccrual status.
5. Evaluate the bank with respect to—
  - a. the adequacy of written policies and procedures relating to real estate loans;
  - b. the operating compliance with established bank policy;
  - c. favorable or adverse trends in the overall real estate lending activity;
  - d. the accuracy and completeness of the bank's records;
  - e. the adequacy of internal controls;
  - f. adherence to lending policies, procedures, and authority by all appropriate personnel;
  - g. compliance with laws, regulations, and Federal Reserve policy on real estate lending activity, including lending limits and restrictions; loans to officers, directors, and shareholders; appraisal and evaluation of real estate collateral; and lending practices;
  - h. compliance with the Interagency Guidelines for Real Estate Lending Policies, including whether the bank is adequately documenting exceptions to supervisory loan-to-value (LTV) limits, whether the volume of nonconforming loans exceeds the capital limitations, and whether risk-management programs have been established and maintained to identify, measure, monitor, and control the inherent risks associated with high-LTV lending;
6. Select loans for examination, using an appropriate sampling technique drawn from judgmental (cutoff-amount approach) or statistical sampling. Analyze the performance of the loans selected for review by transcribing the appropriate information from the following list onto the real estate loan line cards, when applicable:
  - a. collateral records and credit files
  - b. loan agreements relative to any purchases, transfers, participations, or sales that have been entered into since the last examination
  - c. loan commitments and other contingent liabilities
  - d. loan-modification agreements or restructuring terms to identify a reduction in interest rate or principal payments, deferral of interest or principal payments, or other restructurings of terms
  - e. past-due/nonaccrual-related information
  - f. loan-specific internal information from problem credit analyses
  - g. escrow-analysis reports, including the status of property tax payments and escrow advances by the bank to cover delinquent property taxes
  - h. the status of mortgage insurance claims either for government insurance or guarantee programs or for private mortgage insurance, including procedures for ensuring coverage and reporting procedures for filing claims and contested claims, if any

- i. loans to insiders and their interests
7. In analyzing the selected real estate loans, consider the following procedures, taking appropriate action if necessary:
  - a. Determine the primary source of repayment and evaluate its adequacy.
  - b. Assess the quality of any secondary collateral afforded by the loan guarantors or partners.
  - c. Compare collateral values with outstanding debt. Determine whether the loan's LTV ratio is in excess of the supervisory LTV limits. If so, ascertain whether the loan has been properly reported as a nonconforming loan.
  - d. Assess the adequacy of the appraisal or evaluation.
  - e. Ascertain whether the loan complies with established bank policy.
  - f. Identify any deficiencies in the loan's documentation in the credit files, the collateral records, or both.
  - g. Identify whether the loan is to an officer, a director, or a shareholder of the bank or to a correspondent bank. Determine whether an officer, a director, or a shareholder of the bank is a guarantor on the loan.
  - h. Review the borrower's compliance with provisions of the loan agreement. Review the borrower's payment performance, indicating whether the loan is past due.
  - i. Determine if there are any problems that may jeopardize the repayment of the real estate loan.
  - j. Determine whether the loan was classified during the preceding examination, and, if the loan has been paid off, whether all or part of the funds for repayment came from another loan at the bank, from a participation or sale with another institution, or from the repossession of the property.
  - k. Identify whether the loan is to a firm or to individuals who are principals of a firm that provided professional services to the bank, including attorneys, accountants, and appraisers. If so, determine if the loan has received preferential treatment.
8. For loan participations, either in whole or in part, to or with another lending institution, review, if applicable—
  - a. participation certificates and agreements, on a test basis, to determine if the contractual terms are being adhered to;
  - b. loan documentation to see if it meets the bank's underwriting procedures (that is, the documentation for loan participations should meet the same standards as the documentation for loans the bank originates);
  - c. the transfer of loans immediately before the date of the examination to determine if the loan was either nonperforming or classified and if the transfer was made to avoid possible criticism during the current examination; and
  - d. losses to determine if such losses are shared on a pro rata basis.
9. For participations between an institution that has a different primary regulator and loans in the Shared National Credit program—
  - a. identify loans to be included in the Shared National Credit review;
  - b. inform the Reserve Bank of any criticized participation loans that were not covered by the Shared National Credit program and in which the participant(s) had a different primary regulator; and
  - c. inform the Reserve Bank of those loans eligible for the Shared National Credit program that were not previously reviewed.
10. In connection with the examination of other lending activity in the bank—
  - a. check the central liability file on the borrower(s) and determine whether the total indebtedness of the borrower exceeds the lending limit to a single borrower; and
  - b. obtain information and related performance status on common borrowers and their interests from examiners assigned to other examination areas (such as non-real estate loans, leasing, overdrafts, and cash items). Determine the total indebtedness of these borrowers to the bank. Additionally, one examiner should be assigned to review the borrower's overall borrowing relationship with the bank.
11. Consult with the examiner responsible for the asset-liability management analysis portion of the examination to determine the appropriate maturity breakdown of real estate loans needed for the analysis. Prepare the necessary schedules.
12. Summarize the findings of the real estate

loan portfolio review and address the following:

- a. the scope of the examination
- b. the quality of the policies, procedures, and controls
- c. the general level of adherence to policies and procedures
- d. the competency of management and loan officers, including the identification of individuals with an excessively high level of problem loans or documentation exceptions
- e. the quality of the loan portfolio
- f. loans not supported by current and complete financial information
- g. loans with incomplete documentation, addressing deficiencies related to items such as appraisals or evaluations, title policy, proof of insurance, deeds of trust, and mortgage notes
- h. loans to officers, directors, shareholders, or their interests
- i. causes of existing problems
- j. delinquent loans and the aggregate amount of statutory bad debts. (See section 2060.1, "Classification of Credits.")
- k. concentrations of credits
  - l. classified loans
- m. violations of laws, regulations, and Federal Reserve policy
- n. action taken by management to correct previously noted deficiencies, and corrective actions recommended to management at this examination, with the bank's response to them

## Home Equity Lending

1. Review the credit policies for home equity lending to determine if the underwriting standards address all relevant risk factors (that is, an analysis of a borrower's income and debt levels, credit score, and credit history versus the loan's size, the collateral value (including valuation methodology), the lien position, and the property type and location).
2. Determine whether the financial institution's underwriting standards include—
  - a. a properly documented evaluation of the borrower's financial capacity to adequately service the debt;
  - b. an adequately documented evaluation of

the borrower's ability to (1) amortize the fully drawn line of credit over the loan term and (2) absorb potential increases in interest rates for interest-only and variable-rate home equity lines of credit (HELOCs).

3. Assess the reasonableness and adequacy of the analyses and methodologies underlying the financial institution's evaluation of borrowers.
4. If the financial institution uses third parties to originate home equity loans, find out—
  - a. if the institution delegates the underwriting function to a broker or correspondent;
  - b. if the institution's internal controls for delegated underwriting are adequate;
  - c. whether the institution retains appropriate oversight of all critical loan-processing activities, such as verification of income and employment and the independence of the appraisal and evaluation function;
  - d. if there are adequate systems and controls to ensure that a third-party originator is appropriately managed, is financially sound, provides mortgages that meet the institution's prescribed underwriting guidelines, and adheres to applicable consumer protection laws and regulations;
  - e. if the institution has a quality-control unit or function that closely monitors (monitoring activities should include post-purchase underwriting reviews and ongoing portfolio-performance-management activities) the quality of loans that the third party underwrites; and
  - f. whether the institution has adequate audit procedures and controls to verify that third parties are not being paid to generate incomplete or fraudulent mortgage applications or are not otherwise receiving referral or unearned income or fees contrary to RESPA prohibitions.
5. Evaluate the adequacy of the financial institution's collateral-valuation policies and procedures. Ascertain whether the institution—
  - a. establishes criteria for determining the appropriate valuation methodology for a particular transaction (based on the risk in the transaction and loan portfolio);
  - b. sets criteria for determining when a physi-



- cal inspection of the collateral is necessary;
- c. ensures that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation;
  - d. implements policies and controls to preclude “value shopping”; and
  - e. requires sufficient documentation to support the collateral valuation in the appraisal or evaluation.
6. If the financial institution uses automated valuation models (AVMs) to support evaluations or appraisals, find out if the institution—
    - a. implements policies and controls to preclude “value shopping” in its use of AVMs;
    - b. periodically validates the models, to mitigate the potential valuation uncertainty in the model;
    - c. adequately documents the validation’s analysis, assumptions, and conclusions;
    - d. back-tests a representative sample of evaluations and appraisals supporting loans outstanding; and
    - e. evaluates the reasonableness and adequacy of its procedures for validating AVMs.
  7. If tax-assessment valuations are used as a basis for collateral valuation, ascertain whether the financial institution is able to demonstrate and document the correlation between the assessment value of the taxing authority and the property’s market value, as part of the validation process.
  8. Review the risk- and account-management procedures. Verify that the procedures are appropriate for the size of the financial institution’s loan portfolio, as well as for the risks associated with the types of home equity lending conducted by the institution.
  9. If the financial institution has large home equity loan portfolios or portfolios with high-risk characteristics, determine if the institution—
    - a. periodically refreshes credit-risk scores on all customers;
    - b. uses behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts;
    - c. periodically assesses utilization rates;
    - d. periodically assesses payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the credit line to keep payments current;
  - e. monitors home values by geographic area; and
  - f. obtains updated information on the collateral’s value when significant market factors indicate a potential decline in home values, or when the borrower’s payment performance deteriorates and greater reliance is placed on the collateral.
- Determine if the frequency of the above actions is commensurate with the risk in the portfolio.
10. Verify that annual credit reviews of HELOC accounts are conducted. Verify if the reviews of HELOC accounts determine whether the line of credit should be continued, based on the borrower’s current financial condition.
  11. Determine that authorizations of over-limit home equity lines of credit are restricted and subject to appropriate policies and controls.
    - a. Verify that the financial institution requires over-limit borrowers to repay, in a timely manner, the amount that exceeds established credit limits.
    - b. Evaluate the sufficiency of management information systems (MIS) that enable management to identify, measure, monitor, and control the risks associated with over-limit accounts.
  12. Verify that the financial institution’s real estate lending policies are consistent with safe and sound banking practices and that its board of directors reviews and approves the policies at least annually.
  13. Determine whether the MIS—
    - a. allows for the segmentation of the loan portfolios;
    - b. accurately assesses key risk characteristics; and
    - c. provides management with sufficient information to identify, monitor, measure, and control home equity concentrations.
  14. Determine whether management periodically assesses the adequacy of its MIS, in light of growth and changes in the financial institution’s risk appetite.
  15. If the financial institution has significant concentrations of HELs or HELOCs, determine if the MIS includes, at a minimum, reports and analysis of the following:
    - a. production and portfolio trends by prod-

- uct, loan structure, originator channel, credit score, loan to value (LTV), debt to income (DTI), lien position, documentation type, market, and property type
- b. the delinquency and loss-distribution trends by product and originator channel, with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, DTI)
  - c. vintage tracking
  - d. the performance of third-party originators (brokers and correspondents)
  - e. market trends by geographic area and property type, to identify areas of rapidly appreciating or depreciating housing values.
16. Determine whether the financial institution accurately tracks the volume of high-LTV (HLTV) loans, including HLTV home equity and residential mortgages, and if the financial institution reports the aggregate of these loans to its board of directors.
  17. Determine whether loans in excess of the supervisory LTV limits are identified as high-LTV loans in the financial institution's records. Determine whether the institution reports, on a quarterly basis, the dollar value of such loans to its board of directors.
  18. Find out whether the financial institution has purchased insurance products to help mitigate the credit risks of its HLTV residential loans. If a policy has a coverage limit, determine whether the coverage may be exhausted before all loans in the pool mature or pay off.
  19. Determine whether the financial institution's credit risk-management function oversees the support function(s). Evaluate the effectiveness of controls and procedures over staff who are responsible for perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes.
  20. Determine whether policies and procedures have been established for home equity problem-loan workouts and loss-mitigation strategies.
  21. Summarize the findings of the home equity loan portfolio review.

# Real Estate Loans

## Internal Control Questionnaire

Effective date November 2005

## Section 2090.4

Review the bank's internal controls, policies, practices, and procedures for making and servicing real estate loans. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Negative responses to the questions in this section should be explained, and additional procedures deemed necessary should be discussed with the examiner-in-charge. Items marked with an asterisk require substantiation by observation or testing.

### LOAN POLICIES

1. Has the board of directors and management, consistent with their duties and responsibilities, adopted and, at least annually, reviewed and approved written real estate loan policies that define—
  - a. the institution's target market?
  - b. loan portfolio diversification standards?
  - c. acceptable collateral types?
  - d. prudent, clear, and measurable underwriting standards, including relevant credit factors such as—
    - maximum loan amount by type of property?
    - maximum loan maturity by type of property?
    - repayment terms?
    - pricing structure for each type of real estate loan?
    - loan-to-value (LTV) limits by type of property?
  - e. procedures for reviewing real estate loan applications?
  - f. loan-origination and -approval procedures (including loan-authority limits) by size and type of loan?
  - g. review and approval procedures for exception loans?
  - h. loan-administration procedures that include documentation, disbursement, collateral inspection, collection, and loan review?
  - i. minimum loan-documentation standards, such as minimum frequency and
- type of financial information required for each category of real estate loan?
- j. LTV limits that are consistent with regulatory supervisory limits?
- k. real estate appraisal and evaluation programs consistent with the Federal Reserve's appraisal regulation, guidelines, and the October 27, 2003, inter-agency statement on Independent Appraisal and Evaluation Functions (see SR-03-18)?
- l. reporting requirements to the board of directors relative to loan portfolio monitoring, including items such as compliance with lending policies and procedures, delinquency trends, and problem loans?
2. Are real estate policies and objectives appropriate to the size and sophistication of the bank, and are they compatible with changing market conditions?

### LOAN RECORDS

- \*1. Are the preparation and posting of subsidiary real estate loan records performed or adequately reviewed by persons who do not also—
  - a. issue official checks and drafts?
  - b. handle cash receipts?
  - c. reconcile subsidiary records to general ledger controls?
- \*2. Are the subsidiary real estate loan records reconciled at least monthly to the appropriate general ledger accounts? Are reconciling items adequately investigated by persons who do not also handle cash or prepare/post subsidiary controls?
3. Are loans in excess of supervisory LTV limits identified in the bank's records, and are the aggregate amounts of such loans reported at least quarterly to the board of directors, along with the experience of the high-LTV loan portfolio?
4. Are loan statements, delinquent-account-collection requests, and past-due notices reconciled to the real estate loan subsidiary records? Are the notices and reconciliations handled by persons who do not also handle cash?

5. Are inquiries about loan balances received and investigated by persons who do not also handle cash?
  - \*6. Are documents supporting recorded credit adjustments subsequently checked or tested by persons who do not also handle cash?
  7. Does the bank maintain a daily record summarizing note-transaction details (loans made, payments received, and interest collected) to support applicable general ledger account entries?
  8. Are note and liability trial balances frequently reconciled to the general ledger by employees who do not process or record loan transactions?
  9. Are subsidiary payment records and files pertaining to serviced loans segregated and identifiable?
  10. Are past-due-loan reports generated daily?
- b. Does the bank use a check sheet to ensure that required documents are received and on file?
  - c. Are safeguards in effect to protect notes and other documents?
  - d. Does the bank obtain a signed application form for all real estate mortgage loan requests?
  - e. Are separate credit files maintained?
  - f. Is there a program of systematic follow-up to determine that all required documents are received after the loan closing and from public recording offices?
  - g. Does a designated employee conduct a review after loan closing to determine if all documents are properly drawn, executed, recorded, and filed within the loan files?
  - h. Are all notes and other instruments pertaining to paid-off loans returned promptly to the borrower, canceled, and marked paid, where appropriate?
  - i. Are charged-off notes and related files segregated and adequately controlled?

## LOAN INTEREST AND COMMITMENT FEES

- \*1. Are the preparation and posting of loan interest and fee records performed or adequately reviewed by persons who do not also—
  - a. issue official checks or drafts?
  - b. handle cash?
2. Are any independent interest and fee computations made and compared with or adequately tested to loan interest records by persons who do not also—
  - a. issue official checks or drafts?
  - b. handle cash?

## LOAN ORIGINATION

1. Does the bank have a written schedule of fees, rates, terms, and types of collateral for all new loans?
2. Does the bank have a mortgage errors and omission policy?
3. Are procedures in effect to ensure compliance with the requirements of governmental agencies that insure or guarantee loans or with the requirements of private mortgage insurance companies?

## PROCESSING AND DOCUMENT CONTROL

- \*1. Are all real estate loan commitments issued in written form?
2. Are loan officers prohibited from processing loan payments?
- \*3. Are loan payments received by mail recorded upon receipt independently before being sent to and processed by a note teller?
- \*4. Regarding mortgage documents—
  - a. Has the responsibility for the document files been established?

## ESCROW PROCESSING

1. Regarding insurance and property taxes coverage—
  - a. Is there a procedure for determining that private mortgage insurance premiums are current on insured loans?
  - b. Is there a procedure for determining that property and hazard insurance premiums are current on properties securing loans?
  - c. Does the bank require that the hazard insurance policies include a loss-payable

clause to the bank?

- d. Are escrow accounts reviewed at least annually to determine if monthly deposits will cover anticipated disbursements?
- e. Are disbursements for taxes and insurance supported by records showing the nature and purpose of the disbursement?
- f. If advance deposits for taxes and insurance are not required, does the bank have a system to determine that taxes and insurance are being paid?

## LOAN ADMINISTRATION

- \*1. Are approvals of real estate advances reviewed, before disbursement, to determine that such advances do not increase the borrower's total liability to an amount in excess of the bank's legal lending limit?
2. Are detailed statements of account balances and activity mailed to mortgagors at least annually?

## COLLECTIONS AND FORECLOSURES

1. Does the bank have adequate collection procedures to monitor delinquencies and, as necessary, have procedures to pursue foreclosure?
2. Are properties under foreclosure proceedings segregated?
3. Are properties to which the bank has obtained title appropriately transferred to other real estate owned (OREO)? See "Other Real Estate Owned," section 2200.1, for requirements.
4. Does the bank have an adequate management and sales disposition program for timely liquidation of OREO? Does the program take into account the maximum retention period for OREO allowed under state law?
5. Does the bank have adequate procedures for filing and monitoring its mortgage insurance claims for government-insured or -secured programs and for private mortgage insurance?

## HOME EQUITY LENDING

### Policies

1. Do the credit policies for home equity lending address the underwriting standards for all relevant risk factors, such as—
  - a. an analysis of a borrower's income and debt levels?
  - b. an analysis of a borrower's credit score and credit history versus the loan's size?
  - c. the collateral value (including valuation methodology)?
  - d. the lien position?
  - e. the property type and location?
2. Are the financial institution's risk- and account-management procedures appropriate for the size of the institution's loan portfolio, as well as for the risks associated with the types of home equity lending conducted by the institution?
3. Does the financial institution have reasonable and adequate policies and procedures for home equity problem-loan workouts and loss-mitigation strategies?

### Underwriting

4. Has the financial institution purchased insurance products to mitigate the credit risks of its high-LTV (HLTV) residential loans?
  - a. If so, do any of those insurance policies have a coverage limit?
  - b. Has the institution conducted reasonable and adequate analyses to determine whether the coverage may be exhausted before all loans in the pool covered by the insurance product mature or pay off?
5. Does the financial institution's credit-risk management function oversee the support function(s) for its real estate lending? Does the institution have effective controls and procedures over staff who are responsible for perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes?
6. Do the financial institution's underwriting standards include—
  - a. a properly documented evaluation of the borrower's financial capacity to

- adequately service the debt?
- b. an adequately documented evaluation of the borrower's ability to—
    - amortize the fully drawn line of credit over the loan term?
    - absorb potential increases in interest rates for interest-only and variable-rate home equity lines of credit (HELOCs)?
7. Are the analyses and methodologies underlying the institution's evaluation of borrowers reasonable and adequate?
  8. Does the financial institution use third parties to originate home equity loans? If so, does the institution—
    - a. delegate the underwriting function to a broker or correspondent?
    - b. have adequate internal controls for its delegated underwriting?
    - c. retain appropriate oversight of all critical loan-processing activities, such as verification of income and employment and the independence of the appraisal and evaluation function?
    - d. have adequate systems and controls to ensure that a third-party originator is appropriately managed, is financially sound, provides mortgages that meet the institution's prescribed underwriting guidelines, and adheres to applicable consumer protection laws and regulations?
    - e. have a quality-control unit or function that closely monitors (monitoring activities should include post-purchase underwriting reviews and ongoing portfolio-performance-management activities) the quality of loans that the third party underwrites?
    - f. have adequate audit procedures and controls to verify that third parties are not being paid to generate incomplete or fraudulent mortgage applications and are not otherwise receiving referral or unearned income or fees contrary to RESPA prohibitions?
  10. Does the financial institution use automated valuation models (AVMs) to support evaluations or appraisals? If so, does the institution—
    - a. periodically validate the models, to mitigate the potential valuation uncertainty in the model?
    - b. adequately document the validation's analysis, assumptions, and conclusions?
    - c. implement controls to preclude "value shopping" in its use of AVMs?
    - d. back-test a representative sample of evaluations and appraisals supporting loans outstanding?
    - e. evaluate the reasonableness and adequacy of its procedures for validating AVMs?
  11. Are tax-assessment valuations used as a basis for collateral valuation? If so, is the financial institution able to demonstrate and document the correlation between the assessment value of the taxing authority and the property's market value, as part of the validation process?

## Risk Concentrations

12. Does the financial institution have large home equity loan portfolios or portfolios with high-risk characteristics? If so, does the institution—
  - a. periodically refresh credit-risk scores on all customers?
  - b. use behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts?
  - c. periodically assess utilization rates?

## Collateral Valuation

9. Does the financial institution have adequate collateral-valuation policies and procedures that—
  - a. establish criteria for determining the

- d. periodically assess payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the credit line to keep payments current?
- e. monitor home values by geographic area?
- f. obtain updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral?

Are the frequency of these actions commensurate with the risk in the portfolio?

## Management Information Systems

13. Are the financial institution's real estate lending policies consistent with safe and sound banking practices, and does its board of directors review and approve the policies at least annually?
14. Do the financial institution's management information systems (MIS) for real estate lending—
  - a. allow for the segmentation of the loan portfolios?
  - b. accurately assess key risk characteristics?
  - c. provide management with sufficient information to identify, monitor, measure, and control home equity concentrations?
15. Does the financial institution's management periodically assess the adequacy of its MIS, in light of growth and changes in the institution's risk appetite?
16. Does the financial institution have significant concentrations of HELs or HELOCs? If so, does the MIS include, at a minimum, reports and analysis of—
  - a. production and portfolio trends by product, loan structure, originator channel, credit score, loan to value (LTV), debt to income (DTI), lien position, documentation type, market, and property type?
  - b. the delinquency and loss-distribution trends, by product and originator channel, with some accompanying analysis of significant underwriting characteris-

tics (such as credit score, LTV, or DTI)?

- c. vintage tracking?
  - d. the performance of third-party originators (brokers and correspondents)?
  - e. market trends by geographic area and property type, to identify areas of rapidly appreciating or depreciating housing values?
17. Do the financial institution's records identify loans in excess of the supervisory LTV limits as high-LTV (HLTV) loans? Is the aggregate dollar value of such loans reported quarterly to the institution's board of directors? Does the volume of HLTV loans exceed 100 percent of the institution's capital?

## Internal Loan Review

18. Does the financial institution conduct annual credit reviews of HELOC accounts? Does the review of HELOC accounts determine whether the line of credit should be continued, based on the borrower's current financial condition?
19. Are the financial institution's authorizations of over-limit home equity lines of credit restricted? Are they subject to appropriate policies and controls?
  - a. Does the institution require over-limit borrowers to repay, in a timely manner, the amount that exceeds established credit limits?
  - b. Is MIS sufficient to enable management to identify, measure, monitor, and control the risks associated with over-limit accounts?

## CONCLUSION

1. Does the foregoing information provide an adequate basis for evaluating internal control in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
2. On the basis of a composite evaluation, are internal controls adequate, as evidenced by answers to the foregoing questions?

A construction loan is used to finance the construction of a particular project within a specified period of time and is funded by supervised disbursements of a predetermined amount over the construction period. When properly controlled, a bank can promote commercial or residential development through its construction lending as well as receive significant profits over a relatively short time frame. However, the higher rate of return demanded by construction lenders is indicative of the higher risks assumed.

Inasmuch as construction lending is a form of interim financing, loan repayment is contingent on whether the borrower either obtains permanent financing or finds a buyer with sufficient funds to purchase the completed project. Because many borrowers anticipate retaining ownership after construction, the cost and availability of funds from permanent financing is a primary factor to be considered by the bank in assessing the risk of a construction loan.

A construction loan is generally secured by a first mortgage or deed of trust on the land and improvements, which is often backed by a purchase agreement from a financially sound investor or by a takeout financing agreement from a responsible permanent lender. A long-term mortgage loan (permanent financing) is typically obtained before or simultaneously with the construction loan and is made to refinance the short-term construction loan. Additionally, the bank may require a borrower to provide secondary collateral in the form of a junior interest in another real estate project or a personal guarantee.

## BANK LENDING POLICY

Banks can limit the risk inherent in construction lending by establishing policies that specify the type and extent of bank involvement. The bank's lending policies should reflect prudent lending standards and set forth pricing guidelines, limits on loan-to-value ratios and debt-coverage ratios, and yield requirements. Such policies should also address procedures relative to controlling disbursements in a manner that is commensurate with the progress of construction.

## Lending Limits

A bank should have established and well-controlled construction lending limits that are within the acceptable standards of state banking regulations. State banking statutes governing construction lending may contain minimum standards of prudence without specifying actual loan terms.

The bank's internal limits should not exceed the supervisory loan-to-value (LTV) limits set forth in the Interagency Guidelines for Real Estate Lending Policies, as required by the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 USC 1828(c)) and included as appendix C of the Federal Reserve's Regulation H. These guidelines and the accompanying LTV limits are discussed in "Real Estate Loans," section 2090.1. Generally, the LTV ratio should not exceed the following supervisory limits:

- 65 percent for raw-land loans
- 75 percent for land-development and improved-land loans
- 80 percent for commercial, multifamily, and other nonresidential construction loans
- 85 percent for one- to four-family residential construction loans

For loans that fund multiple phases of the same real estate project, the appropriate LTV limit is the supervisory LTV limit applicable to the final phase of the project.

## Lending Risks

Construction loans are vulnerable to a wide variety of risks. Critical to the evaluation of any construction loan is the analysis of the project's feasibility study to ascertain the developer's risk, which affects the lender's risk. The major portion of the risk is attributable to the need to complete a project within specified cost and time limits. Examples of difficulties that may arise include—

- completion of a project after takeout dates, which voids permanent funding commitments;



- cost overruns, which may exceed takeout commitments or sale prices;
- the possibility that the completed project will be an economic failure;
- the diversion of progress payments, resulting in nonpayment of material bills or subcontractors;
- a financial collapse or the failure of the contractors, subcontractors, or suppliers to perform before the completion date;
- increased material or labor costs;
- the destruction of improvements from unexpected natural causes; and
- an improper or lax monitoring of funds advanced by the bank.

## TYPES OF CONSTRUCTION LOANS

The basic types of construction lending are unsecured front-money, land-development, residential construction, and commercial construction loans. It is not uncommon for a bank to provide the acquisition, development, and construction loans for a particular project.

### Unsecured Front-Money Loans

Front-money loans are considered very risky and should not be undertaken unless the bank has the expertise to evaluate the credit risk. These loans may represent working-capital advances to a borrower who may be engaged in a new and unproven venture. The funds may be used to acquire or develop a building site, eliminate title impediments, pay architect or standby fees, and meet minimum working-capital requirements established by construction lenders. Because repayment often comes from the first draw against construction financing, many construction loan agreements prohibit the use of the first advance to repay nonconstruction costs. Unsecured front-money loans used as a developer's equity investment in a project or to cover initial cost overruns are symptomatic of an undercapitalized or possibly an inexperienced or inept builder.

### Land-Development Loans

Land-development or off-site-improvement loans are intended to be secured-purchase loans or

unsecured advances to creditworthy borrowers. A development loan involves the purchase of land and lot development in anticipation of further construction or sale of the property. In addition to funding the acquisition of the land, a development loan may be used to fund the preparation of the land for future construction, including the grading of land, installation of utilities, and construction of streets.

Effective administration of a land-development loan begins with a plan defining each step of the development. The development plan should incorporate cost budgets, including legal expenses for building and zoning permits, environmental impact statements, costs of installing utilities, and all other projected costs of the development. Bank management's review of the plan and related cost breakdowns should provide the basis for determining the size, terms, and restrictions for the development loan. Refer to the subsection below on the assessment of real estate collateral for further discussion.

The LTV ratio should provide for sufficient margin to protect the bank from unforeseen events (such as unplanned expenses) that would otherwise jeopardize the bank's collateral position or repayment prospects. If the loan involves the periodic development and sale of portions of the property under lien, each separately identifiable section of the project should be independently appraised, and any collateral should be released in a manner that maintains a reasonable margin. The repayment program should be structured to follow the sales or development program. Control over development loans can be best established when the bank finances both the development and the construction or sale phases of the project.

In the case of an unsecured land-development loan, it is essential to analyze the borrower's financial statements to determine the source of loan repayment. In establishing the repayment program, the bank should review sales projections to ensure that they are not overly optimistic. Additionally, banks should avoid granting loans to illiquid borrowers or guarantors who provide the primary support for a borrower (project).

### Residential Construction Loans

Residential construction loans are made either on a speculative basis, where homes are built to

be sold later in the general market, or for a specific buyer with prearranged permanent financing. Loans financing residential projects that do not have prearranged homebuyer financing are usually limited to a predetermined number of speculative homes, which are permitted to get the project started. However, smaller banks are often engaged in this type of financing, and the aggregate total of individual speculative construction loans may equal a significant portion of their capital funds. It is important to ensure that the homebuyer has arranged permanent financing before the bank finances the construction; otherwise, the bank may find itself without a source of repayment. Construction loans without takeout commitments generally should be aggregated to determine whether a concentration of credit exists, that is, in those situations when the amount exceeds 25 percent of the bank's capital structure (tier 1 capital plus loan loss reserves).

Proposals to finance speculative construction should be evaluated according to predetermined policies that are compatible with the institution's size, the technical competence of its management, and the housing needs of its service area. The prospective borrower's reputation, experience, and financial condition should also be reviewed to assess the likelihood of completing the proposed project. Until the project is completed, the actual value of the real estate is questionable. Thus, the marketability of the project should be substantiated in a feasibility study, reflecting a realistic assessment of current favorable and unfavorable local housing market conditions. As in any real estate loan, the bank must also obtain an appraisal or evaluation for the project. The appraisal or evaluation and the feasibility study are important tools to be used by lenders in evaluating project risks. For projects located out of area, the lender may lack market expertise, which makes evaluating the reasonableness of the marketing plan and feasibility study more difficult, and therefore makes the loan inherently riskier.

A bank dealing with speculative builders should have control procedures tailored to the individual project. A predetermined limit on the number of unsold units to be financed at any one time should be included in the loan agreement to avoid overextending the builder's capacity. The construction lender should receive current inspection reports indicating the project's progress. In some instances, the construction lender is also the permanent mortgagor. Loans on larger resi-

dential construction projects are usually negotiated with prearranged permanent financing as part of the construction loan.

## Commercial Construction Loans

A bank's commercial construction lending activity can encompass a wide range of projects—apartments, condominiums, office buildings, shopping centers, and hotels—with each requiring a special set of skills and expertise to successfully manage, construct, and market.

Commercial construction loan agreements should normally require the borrower to have a precommitted extended-term loan to “take out” the construction lender. Takeout-financing agreements, however, are usually voidable if construction is not completed by the final funding date, if the project does not receive occupancy permits, or if the preleasing or occupancy rate does not meet an agreed-upon level. A bank can also enter into an open-end construction loan where there is no precommitted source to repay the construction loan. Such loans pose an added risk because the bank may be forced into providing permanent financing, oftentimes in distressed situations. In evaluating this risk, the bank should consider whether the completed project will be able to attract extended-term financing, supportable by the projected net operating income.

The risk of commercial construction requires a complete assessment of the real estate collateral, borrower's financial resources, source of the extended-term financing, and construction plans. As it does any real estate loan, the bank must obtain an appraisal or evaluation of the real estate in accordance with the Federal Reserve's appraisal regulation. Additionally, the borrower should provide a feasibility study for the project that details the project's marketing plan, as well as an analysis of the supply-and-demand factors affecting the projected absorption rate. For an open-end construction loan, the feasibility study is particularly important to the bank's assessment of the credit because the repayment of the loan becomes increasingly dependent on the sales program or leasing of the project.

The bank also needs to assess the borrower's development expertise, that is, whether the borrower can complete the project within budget and according to the construction plans. The financial risk of the project is contingent on the

borrower's development expertise because the source of the extended-term loan may be predicated upon a set date for project completion. Until the project is completed, the actual value of the real estate is questionable.

A bank may reduce its financial risk by funding the construction loan after the borrower has funded its share of the project equity (for example, by paying for the feasibility study and land-acquisition and -development costs). An alternative approach would require the borrower to inject its own funds into the project at agreed-upon intervals during the project's management, construction, and marketing phases to coincide with the construction lender's contributions. In larger projects, equity injections can be provided by equity partners or joint ventures. These can take the form of equity syndications,<sup>1</sup> whose contributions are injected in the project in phases. A bank should assess the likelihood of the syndication being able to raise the necessary equity.

## BANK ASSESSMENT OF THE BORROWER

The term *borrower* can refer to different types of entities. These forms can range from an entity whose sole asset is the project being financed to an entity that has other assets available to support the debt in addition to the project being financed (a multi-asset entity).

Although the value of the real estate collateral is an important component of the loan approval process, the bank should not place undue reliance on the collateral value in lieu of an adequate analysis of the borrower's ability to repay the loan. The analytical factors differ depending on the purpose of the loan, such as residential construction versus the various types of commercial construction loans.

The bank's analysis is contained in its documentation files, which should include background information on the borrower and partner/guarantor concerning their character and credit

history, expertise, and financial statements (preferably audited) for the most recent fiscal years. Background information regarding a borrower's and partner's/guarantor's character and credit history is based upon their work experience and previous repayment practices, both relative to trade creditors and financial institutions. The documentation files should indicate whether the borrower has demonstrated it can successfully complete the type of project to be undertaken. The financial statements should be analyzed to ensure that the loan can be repaid in the event that a takeout does not occur.

The degree of analysis depends on whether the borrower is in reality a single-asset entity or a multi-asset entity. A loan to a single-asset entity is often predicated upon the strength of the partners/guarantors. Accordingly, understanding their financial strength, which frequently is made up of various partnership interests, is key to assessing the project's strength. In this example, it would be necessary to obtain financial information on the partner's/guarantor's other projects, even those not financed by the bank, to understand their overall financial condition. This is necessary because other unsuccessful projects may cause financial trouble for the partner/guarantor, despite a successful sales program by the bank's borrower. Issues to be considered, in addition to those raised in the preceding paragraph, include the vacancy rates of the various projects, break-even points, and rent rolls.

A loan to a multi-asset entity has similar characteristics to those found in the single-asset entity, in that it is necessary to evaluate all of the assets contained therein to ascertain the actual financial strength. In both cases, assessment of the project under construction would include pre-leasing requirements. For a loan with a takeout commitment, the financial strength and reputation of the permanent lender should be analyzed. For a loan without a takeout commitment, or one in which the construction lender provides the permanent financing for its construction loan, the long-term risks also need to be evaluated. See the "Real Estate Loans" section in this manual, on the bank's assessment of the borrower, for additional factors to be considered.

In instances where approval for the loan is predicated upon the strength of entities other than the borrower (partner/guarantor), the bank should obtain information on their financial condition, income, liquidity, cash flow, contingent liabilities, and any other relevant factors

<sup>1</sup> *Syndication* generally refers to the act of bringing together a group of individuals or entities to invest in a real estate project and does not refer to any particular legal form of ownership. The legal form varies depending on the investors' investment objectives, division of tax benefits, responsibility for project management, and desire to limit personal liability. The investment vehicle may be a general partnership, limited partnership, joint venture, tenancy in common, corporation, real estate investment trust, or common law trust.

that exist to demonstrate their financial capacity to fulfill the obligation in the event that the borrower defaults.

Partners/guarantors generally have investments in other projects included as assets on their financial statements. The value of these investments frequently represents the partner's/guarantor's own estimate of the investment's worth, as opposed to a value based upon the investment's financial statements. As a result, it is necessary to obtain detailed financial statements for each investment to understand the partner's/guarantor's complete financial picture and capacity to support the loan. The statements should include detailed current and accurate cash-flow information since cash flow is often the source of repayment.

It is also important to consider the number and amount of the guarantees currently extended by a partner/guarantor to determine if they have the financial capacity to fulfill the contingent claims that exist. Furthermore, the bank should review the prior performance of the partner/guarantor to voluntarily honor the guarantee as well as the marketability of the assets collateralizing the guarantee. Since the guarantee can be limited to development and construction phases of a project, the bank should closely monitor the project before issuing a release to the partner/guarantor.

## BANK ASSESSMENT OF REAL ESTATE COLLATERAL

Banks should obtain an appraisal or evaluation, as appropriate, for all real estate-related financial transactions before making the final credit or other decision. See "Real Estate Appraisals and Evaluations," section 4140.1, for a description of the related requirements a bank must follow for real estate-related financial transactions. The appraisal section explains the standards for appraisals, indicates which transactions require an appraisal or an evaluation, states qualifications for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal approaches.

The appraisal or evaluation techniques used to value a proposed construction project are essentially the same as those used for other types of real estate. The aggregate principal amount of the loan should be based on an appraisal or evaluation that provides, at a mini-

um, the "as is" market value of the property.<sup>2</sup> Additionally, the bank will normally request the appraiser to report the "as completed" value.<sup>3</sup> Projections should be accompanied by a feasibility study explaining the effect of projected property improvements on the market value of the land. The feasibility study may be a separate report or incorporated into the appraisal report. If the appraiser uses the feasibility study, the appraiser's acceptance or rejection of the study and its effect on the value should be fully explained in the appraisal. An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish and maintain an effective, independent real estate appraisal and evaluation program (the program) for all of its lending functions. The real estate lending functions include commercial real estate mortgage departments, capital-market groups, and asset-securitization and -sales units. Concerns about the independence of real estate appraisal and evaluation programs include the risk that improperly prepared appraisals and evaluations may undermine the integrity of credit-underwriting processes. More broadly, an institution's lending functions should not have undue influence that might compromise the program's independence. See the October 27, 2003, interagency statement on Independent Appraisal and Evaluation Functions (SR-03-18).

Management is responsible for reviewing the reasonableness of the appraisal's or evaluation's assumptions and conclusions. Also, management's rationale in accepting and relying upon the appraisal or evaluation should be in writing and made a part of loan documentation. In assessing the underwriting risks, management should reconsider any assumptions used by an appraiser that reflect overly optimistic or pessimistic values. If management, after its review of the appraisal or evaluation, determines that there

2. The "as is" value is the value of the property in its current physical condition and subject to the zoning in effect as of the date of appraisal.

3. The "as completed" value reflects the value of the land and the projected improvements. A bank may also request a value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development. For proposed residential developments that involve the sale of individual houses, units, or lots, the appraisal should reflect deductions and discounts for holding costs, marketing costs, and entrepreneurial profit. For proposed and rehabilitated income-producing properties, the appraisal should reflect appropriate deductions and discounts for leasing commissions, rent losses, and tenant improvements from the estimated value based on stabilized occupancy.

are unsubstantiated assumptions, the bank may request the appraiser or evaluator to provide a more detailed justification of the assumptions or a new appraisal or evaluation. The approval of the loan is based upon the value of the project after the construction is completed. Insofar as the value component of the loan-to-value ratio is concerned, it is important for the bank to closely monitor the project's progress (value) during the construction period. See "Real Estate Loans," section 2090.1, for additional information relative to the real estate collateral assessment.

## LOAN DOCUMENTATION

The loan documentation should provide information on the essential details of the loan transaction, the security interest in the real estate collateral, and the takeout loan commitment, if any. The necessary documentation before the start of construction generally includes:

- Financial and background information on the borrower to substantiate the borrower's expertise and financial strength to complete the project.
- The construction loan agreement, which sets forth the rights and obligations of the lender and borrower, conditions for advancing funds, and events of default. In some states, the agreement must be cited in either the deed of trust or the mortgage.
- A recorded mortgage or deed of trust, which can be used to foreclose and obtain title to the collateral.
- A title insurance binder or policy, usually issued by a recognized title insurance company or, in some states, an attorney's opinion. The title should be updated with each advance of funds to provide additional collateral protection.
- Insurance policies and proof of payment as evidence that the builder has adequate and enforceable coverage for liability, fire and other hazards, and vandalism and malicious mischief losses.
- An appropriate appraisal or evaluation showing the value of the land and improvements to date or, possibly, a master appraisal based on specifications for a multiphase development.
- Project plans, a feasibility study, and a construction budget showing the development plans, project costs, marketing plans, and

equity contributions. A detailed cost breakdown of land, "hard" construction costs, and indirect or "soft" construction costs (such as construction loan interest; organizational and administration costs; and architectural, engineering, and legal fees) should be included.

- Property surveys, easements, an environmental impact report, and soil reports that indicate construction is feasible on the selected development site. The bank should also obtain the architect's certification of the plan's compliance with all applicable building codes and zoning, environmental protection, and other government regulations, as well as the engineer's report on compliance with building codes and standards. If internal expertise is not available, a bank may need to retain an independent construction expert to review these documents to assess the reasonableness and appropriateness of the construction plans and costs.
- The takeout commitment from the permanent lender, if applicable, and the terms of the loan. The bank should verify the financial strength of the permanent lender to fund the takeout commitment.
- A completion or performance bond signed by the borrower that guarantees the borrower will apply the loan proceeds to the project being financed.
- An owners' affidavit or a borrowing resolution empowering the borrower or its representative to enter into the loan agreement.
- Evidence that property taxes have been paid to date.

These documents furnish evidence that the lending officer is obtaining the information necessary for processing and servicing the loan and protect the bank in the event of default.

## Documentation for Residential Construction Loans on Subdivisions

The documents mentioned above are usually available for residential construction loans on subdivisions (tracts). Documentation of tract loans frequently includes a master note in the gross amount of the entire project, and a master deed of trust covering all of the land involved in the project. In addition to an appraisal or evaluation for each type of house to be constructed, the bank should also obtain a master appraisal

including a feasibility study for the entire development. The feasibility study compares the projected demand for housing against the anticipated supply of housing in the market area of the proposed tract development. This analysis should indicate whether there will be sufficient demand for the developer's homes given the project's location, type of homes, and unit sales price.

### Documentation for the Takeout Commitment

Most construction lenders require the developer to have an arrangement for permanent financing for each house to be constructed. Exceptions include model homes, typically one for each style of home offered, and a limited number

of housing starts ahead of sales (speculative houses). The starts ahead of sales, however, contain additional risk. If the bank finances too many houses without purchase contracts, and housing sales decline rapidly, it may have to foreclose on the unsold houses and sell them for less than their loan value. A takeout of this type is usually an arrangement between the developer and a permanent mortgage lender, but construction lenders may also finance the permanent mortgages.

The essential information required for a commercial real estate takeout to proceed includes the floor and ceiling rental rates and minimum occupancy requirements; details of the project being financed; expiration date; standby fee requirement; assignment of rents; and, generally, a requirement that the construction loan be fully disbursed and not in any way in default at the time settlement occurs.

The commitment agreement, referred to as the buy/sell contract or the tri-party agreement, is signed by the borrower, the construction lender, and the permanent lender. The purpose of this agreement is to permit the permanent lender to buy the loan directly from the construction lender upon completion of the construction, with the stipulation that all contingencies have been satisfied. Examples of contingencies include project completion by the required date, clear title to the property, and minimum lease-up requirements. A commitment agreement also protects the construction lender against unforeseen possibilities, such as the death of a principal, before the permanent loan documents are signed.

## ADMINISTERING THE LOAN

The bank and the borrower<sup>4</sup> must effectively cooperate as partners if controls relative to construction progress are to be maintained. The loan agreement specifies the performance of each party during the entire course of construction. Any changes in construction plans should be approved by both the construction lender and

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4. The borrower may not be the entity responsible for the actual construction of the project. Depending on the size, type, and complexity of the project, the borrower may strictly be a developer who assembles the land, designs the project, and contracts with a construction company to handle the actual construction of the building. If this is the case, the bank should obtain financial and project history information on the builder/contractor.

the takeout lender. Construction changes can result in increased costs, which may not necessarily increase the sale value of the completed project. On the other hand, a decrease in costs may not indicate a savings but may suggest the use of lesser quality materials or workmanship, which could affect the marketability of the project.

## Disbursement of Loan Funds

Loan funds are generally disbursed through either a stage payment plan or a progress payment plan. Regardless of the method of disbursement, the amount of each construction draw should be commensurate with the improvements made to date. Funds should not be advanced unless they are used in the project being financed and as stipulated in the draw request. Therefore, the construction lender must monitor the funds being disbursed and must be assured, at every stage of construction, that sufficient funds are available to complete the project.

### *Stage Payment Plan*

The stage payment plan, which is normally applied to residential and smaller commercial construction loans, uses a preestablished schedule for fixed disbursements to the borrower at the end of each specified stage of construction. The amount of the draw is usually based upon the stage of development because residential housing projects normally consist of houses in various stages of construction. Nevertheless, loan agreements involving tract financing typically restrict further advances in the event of an accumulation of completed and unsold houses. Disbursements are made when construction has reached the agreed-upon stages, verified by an actual inspection of the property. These typically include advances at the conclusion of various stages of construction, such as the foundation, exterior framing, the roof, interior finishing, and completion of the house. The final payment is made after the legally stipulated lien period for mechanic's liens has lapsed.

Disbursement programs of this type are usually required for each house constructed within a tract development. As each house is completed and sold, the bank makes a partial release relative to that particular house covered by its

master deed of trust. The amount of the release is set forth in the loan agreement, which specifies the agreed-upon release price for each house sold with any excess over the net sales proceeds remitted to the borrower.

### *Progress Payment Plan*

The progress payment plan is normally used for commercial projects.<sup>5</sup> Under a progress payment system, funds are released as the borrower completes certain phases of construction as agreed upon in the loan agreement. Normally, the bank retains a percentage of the funds as a hold back (or retainage) to cover project cost overruns or outstanding bills from suppliers or subcontractors. Hold backs occur when a developer/contractor uses a number of subcontractors and maintains possession of a portion of the amounts owed to the subcontractors during the construction period. This is done to ensure that the subcontractors finish their work before receiving the final amount owed. Accordingly, the construction lender holds back the same funds from the developer/contractor to avert the risk of their misapplication or misappropriation.

The borrower presents a request for payment from the bank in the form of a “construction draw” request or “certification for payment,” which sets forth the funding request by construction phase and cost category for work that has been completed. This request should be accompanied by receipts for the completed work (material and labor) for which payment is being requested. The borrower also certifies that the conditions of the loan agreement have been met—that all requested funds have been used in the subject project and that suppliers and subcontractors have been paid. Additionally, the subcontractors and suppliers should provide the bank with lien waivers covering the work com-

pleted for which payment has been received. Upon review of the draw request and independent confirmation on the progress of work, the bank will disburse funds for construction costs incurred, less the hold back. The percentage of the loan funds retained are released when a notice of the project’s completion has been filed, and after the stipulated period has elapsed under which subcontractors or suppliers can file a lien.

### **Monitoring Progress of Construction and Loan Draws**

It is critical that a bank has appropriate procedures and an adequate tracking system to monitor payments to ensure that the funds requested are appropriate for the given stage of development. The monitoring occurs through physical inspections of the project once it has started. The results of the inspections are then documented in the inspection reports, which are kept in the appropriate file. Depending on the complexity of the project, the inspection reports can be completed either by the lender or by an independent construction consulting firm, the latter generally staffed by architects and engineers. The reports address both the quantity and the quality of the work for which funds are being requested. They also verify that the plans are being followed and that the construction is proceeding on schedule and within budget.

The bank must be accurately informed of the progress to date in order to monitor the loan. It is also important that the bank ascertain whether draws are being taken in accordance with the predetermined disbursement schedule. Before any draw amount is disbursed, however, the bank must obtain verification of continued title insurance. Generally, this means verifying that no liens have been filed against the title of the project since the previous draw. The title insurance insuring the construction lender’s mortgage or lien is then increased to include the new draw, which results in an increase in the title insurance commensurate with the disbursement of funds. The lender frequently examines title to the property securing the construction loan to also be certain that the borrower is not pledging it for other borrowings and to be sure that mechanic’s liens are not being filed for unpaid bills. When the project is not proceeding as anticipated, that fact should be reflected in the inspection reports.

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5. Other methods for disbursing commercial construction loans include the voucher system and the monthly draw method. The voucher system is similar to the progress system except that borrower prepares a voucher of all invoices to be paid with signatures of the subcontractors attesting to the invoiced amount. The bank then issues checks directly to the subcontractors or suppliers. The monthly draw method is used in long-term projects wherein the borrower makes a draw request each month for the previous month’s work. In turn, the bank determines the amount of work completed to date and releases funds based on the value of work completed versus the value of the work remaining.



Another important component in the process is the ongoing monitoring of general economic factors that will affect the marketing and selling of the residential or commercial properties and affect their success upon completion of the project.

### *Monitoring Residential Projects*

An inventory list is maintained for each tract or phase of the project. The inventory list should show each lot number, the style of house, the release price, the sale price, and the loan balance. The list should be posted daily with advances and payments indicating the balance advanced for each house, date completed, date sold, and date paid, and should age the builder's inventory by listing the older houses completed and unsold.

Inspections (usually monthly) during the course of construction of each house should be documented in progress reports. The progress report should indicate the project's activity during the previous month, reflecting the number of homes under construction, the number completed, and the number sold. The monthly report should indicate whether advances are being made in compliance with the loan agreement.

### *Monitoring Commercial Projects*

To have an effective control over its commercial construction loan program, the bank must have an established loan administration process that continually monitors each project. The process should include monthly reporting on the work completed, the cost to date, the cost to complete, construction deadlines, and loan funds remaining. Any changes in construction plans should be documented and reviewed by the construction consulting firm and should be approved by the bank and takeout lender. A significant number of change orders may indicate poor planning or project design, or problems in construction, and should be tracked and reflected in the project's budget. Soft costs such as advertising and promotional expenses normally are not funded until the marketing of the project has started.

## Final Repayment

Before the final draw is made, the construction

loan should be in a condition to be converted to a permanent loan. Usually the final draw includes payment of the hold back stipulated in the loan agreement and is used to pay all remaining bills. The bank should obtain full waivers of liens (releases) from all contractors, subcontractors, and suppliers before the loan is released and the hold back is disbursed. The bank should also obtain a final inspection report to confirm the project is completed and meets the building specifications, including confirmation of the certificate of occupancy from the governing building authority.

Sources of permanent funding for commercial projects vary greatly, depending upon the type of project. For condominium projects, the construction lender may also be providing the funding for marketing the individual units and would be releasing the loan on a unit-by-unit basis similar to a residential development construction loan. If there is a precommitted takeout lender, the new lender could purchase the construction loan documents and assume the security interest from the construction lender. If the project is being purchased for cash, the bank would release its lien and cancel the note.

Additionally, as the commercial project is leased, the lender should ensure that the bank's position is protected in the event that extended-term funding is not obtained. The bank may require tenants to enter into subordination, attornment, and nondisturbance agreements, which protect the bank's interests in the lease by providing for the assumption of the landlord's position by the bank in the event the borrower declares bankruptcy. Furthermore, to ensure that the bank has full knowledge of all provisions of the lease agreements, tenants should be required to sign an estoppel certification.

In some cases, the takeout lender may only pay off a portion of the construction loan because a conditional requirement for full funding has not been met, such as the project not attaining a certain level of occupancy. The construction lender would then have a second mortgage on the remaining balance of the construction loan. When the conditions of the takeout loan are met, the construction lender is repaid in full and the lien is released.

## Interest Reserves

A construction loan is generally an interest-only loan because of the fact that cash flow is not

available from most projects until they are completed. The borrower's interest expense is therefore borrowed from the construction lender as part of the construction loan for the purpose of "paying" the lender interest on the "portion" of the loan used for actual construction. The funds advanced to pay the interest are included as part of the typical monthly draw. As a result, the balance due to the lender increases with each draw by the full amount of construction costs, plus the interest that is borrowed.

The borrower's interest cost is determined by the amount of credit extended and the length of time needed to complete the project. This interest cost is referred to as an interest reserve. This period of time should be evaluated for reasonableness relative to the project being financed. In larger projects cash flow may be generated prior to the project's completion. In such cases, any income from the project should be applied to debt service before there is a draw on the interest reserve. The lender should closely monitor the lease-up of the project to ensure that the project's net income is being applied to debt service and not diverted to the borrower as a return of the developer's capital or for use in the developer's other projects.

## Loan Default

The inherent exposure in construction financing is that the full value of the collateral is not realized until the project is completed. In default situations the bank must consider the alternatives available to recover its advances. For uncompleted projects, the bank must decide whether it is more advantageous to complete the project or to sell on an "as is" basis. The various mechanic's and materialmen's liens, tax liens, and other judgments that arise in such cases are distressing to even the most seasoned lender. Due to these factors, the construction lender may not be in the preferred position indicated by documents in the file. Therefore, the lender should take every precaution to minimize any third-party claim on the collateral. Because laws regarding the priority of certain liens may vary among states, the bank should take the necessary steps to ensure that its lien is recorded prior to the commencement of work or the delivery of materials and supplies.

## Signs of Problems

To detect signs of a borrower's financial problems, the bank should review the borrower's financial statements on a periodic (quarterly) basis, assessing the liquidity, debt level, and cash flow. The degree of information the financial statements provide the bank, insofar as understanding the borrower's financial condition is concerned, depends primarily on whether the borrower is a single-asset entity or a multi-asset entity.

The financial statements of a single-asset entity only reflect the project being constructed; therefore, they are of a more limited use than statements of multi-asset entities. Nevertheless, one issue that is of importance to financial statements of both entities relates to monitoring changes in accounts and trade payables. Monitoring these payables in a detailed manner helps the bank to determine if trade payables are paid late or if there are any unpaid bills. In the event of problems, a bank might choose to either contact the payables directly or request an additional credit check on the borrower. Another source of information indicating borrower problems is local publications that list lawsuits or judgments that have been filed or entered against the borrower. Additionally, the bank should also verify that the borrower is making its tax payments on time.

In a multi-asset entity, on the other hand, more potential problems could arise due to the greater number of assets (projects/properties) that make up the borrower. As a result, it is necessary to obtain detailed financial statements of each of the assets (projects/properties) and the consolidating financial statements, as well as the consolidated financial statements. This is important because each kind of statement can provide significant insight into problems that could adversely affect the borrower's overall financial condition.

Assessing the financial condition of the multi-asset entity includes evaluating the major sources of cash and determining whether cash flow is dependent on income generated from completed projects, the sale of real estate, or infusion of outside capital. Additionally, the bank should also review the borrower's account receivables for the appropriateness of intercompany transactions and to guard against diversion of funds.

Depending upon the structure of the loan, it may also be desirable to obtain a partner's/

guarantor's financial statements on a periodic basis. In such cases it is important to obtain detailed current and accurate financial statements that include cash flow information on a project-by-project basis.

Slow unit sales, or excessive inventory relative to sales, indicate the borrower may have difficulty repaying the loan. Although sometimes there are mitigating factors beyond the control of the borrower, such as delays in obtaining materials and supplies, adverse weather conditions, or unanticipated site work, the borrower may be unable to overcome these problems. Such delays usually increase project costs and could hamper the loan's repayment.

The construction lender should be aware of funds being misused—for example, rebuilding to meet specification changes not previously disclosed, starting a new project, or possibly paying subcontractors for work performed elsewhere. The practice of "front loading," whereby a builder deliberately overstates the cost of the work to be completed in the early stages of construction, is not uncommon and, if not detected early on, will almost certainly result in insufficient loan funds with which to complete construction in the event of a default.

## Loan Workouts

Sound workout programs begin with a full disclosure of all relevant information based on a realistic evaluation of the borrower's ability to manage the business entity (business, technical, and financial capabilities), and the bank's ability to assist the borrower in developing and monitoring a feasible workout/repayment plan. Management should then decide on a course of action to resolve the problems with the terms of the workout in writing and formally agreed to by the borrower. If additional collateral is accepted or substituted, the bank should ensure that the necessary legal documents are filed to protect the bank's collateral position.

In those cases where the borrower is permitted to finish the project, additional extensions of credit for completing the project, due to cost overruns or an insufficient interest reserve, may represent the best alternative for a workout plan. At the same time, the bank should evaluate the cause of the problem(s), such as mismanagement, and determine whether it is in its best

interest to allow the borrower to complete the project.

## SUPERVISORY POLICY

As a result of competitive pressures, many banks in the early 1980s made construction loans on an open-end basis, wherein the borrower did not have a commitment for longer-term or takeout financing before construction was started. Although there was sufficient demand for commercial real estate space when this practice commenced, the supply of space began to exceed demand. One symptom of the excess supply was an increase in vacancy rates, which led to declining rental income caused by the ever greater need for rent concessions. The commensurate declining cash flow from income-producing properties, and the uncertainty regarding future income, reduced the market value of many properties to levels considered undesirable by permanent mortgage lenders. As a result of the subsequent void created by the permanent lenders, banks in the mid- and late 1980s began to extend medium-term loans with maturities for up to seven years (also referred to as mini-perms). These mini-perms were granted with the expectation by banks that as the excess supply of space declined, the return on investment would improve, and permanent lenders would return.

As these loans mature in the 1990s, borrowers may continue to find it difficult to obtain adequate sources of long-term credit. In some cases, banks may determine that the most desirable and prudent course is to roll over or renew loans to those borrowers who have demonstrated an ability to pay interest on their debts, but who presently may not be in a position to obtain long-term financing for the loan balance.

The act of refinancing or renewing loans to sound borrowers, including creditworthy commercial or residential real estate developers, generally should not be subject to supervisory criticism in the absence of well-defined weaknesses that jeopardize repayment of the loans. Refinancings or renewals should be structured in a manner that is consistent with sound banking, supervisory, and accounting practices, and that protects the bank and improves its prospects for collecting or recovering on the asset.

# Real Estate Construction Loans Examination Objectives

Effective date November 1993

## Section 2100.2

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1. To determine if policies, practices, procedures, and internal controls regarding real estate construction loans are adequate.
2. To determine if bank officers are operating in conformance with the bank's established guidelines.
3. To evaluate the portfolio for collateral sufficiency, performance, credit quality, and collectibility.
4. To determine compliance with applicable laws and regulations.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Real Estate Construction Loans

## Examination Procedures

Effective date November 1993

## Section 2100.3

1. Refer to the Real Estate Loan Examination Procedures section of this manual for examination procedures related to all types of real estate lending activity, and incorporate into this checklist those procedures applicable to the review of the real estate construction loans. The procedures in this checklist are unique to the review of a bank's construction lending activity.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal/external auditors.
3. Test real estate construction loans for compliance with policies, practices, procedures, and internal controls by performing the remaining examination procedures in this section. Also, obtain a listing of any deficiencies noted in the latest internal/external audit reviews and determine if appropriate corrections have been made.
4. Review management reports on the status of construction lending activity, economic developments in the market, and problem loan reports.
5. Evaluate the bank with respect to—
  - a. the adequacy of written policies and procedures relating to construction lending.
  - b. operating compliance with established bank policy.
  - c. favorable or adverse trends in construction lending activity.
  - d. the accuracy and completeness of the bank's records.
  - e. the adequacy of internal controls, including control of construction draws.
  - f. the adherence of lending staff to lending policies, procedures, and authority as well as the bank's adherence to the holding company's loan limits, if applicable.
  - g. compliance with laws, regulations, and Federal Reserve policy on construction lending activity, including supervisory loan-to-value (LTV) limits and restrictions; loans to officers, directors, and shareholders; appraisal and evaluation of real estate collateral; and prudent lending practices.
6. Select loans for examination, using an appropriate sampling technique drawn from judgmental (cut-off line) or statistical sampling. Analyze the performance of the loans selected for examination by transcribing the following kinds of information onto the real estate construction loan line cards, when applicable:
  - a. Collateral records and credit files, including the borrower's financial statements, review of related projects, credit report of the borrower and guarantors, appraisal or evaluation of collateral, feasibility studies, economic impact studies, and loan agreement and terms.
  - b. Loan modification or restructuring agreements to identify loans where interest or principal is not being collected according to the terms of the original loan. Examples include reduction of interest rate or principal payments, deferral of interest or principal payments, or renewal of a loan with accrued interest rolled into the principal.
  - c. The commitment agreement—a buy/sell contract or the tri-party agreement—from the extended-term or permanent lender for the takeout loan.
  - d. Cash-flow projections and any revisions to projections based on cost estimates from change orders.
  - e. Estimates of the time and cost to complete construction.
  - f. Inspection reports and evaluations of the cost to complete, construction deadlines, and quality of construction.
  - g. Construction draw schedules and audits for compliance with the schedules.
  - h. Documentation on payment of insurance and property taxes.
  - i. Terms of a completion or performance bond.
  - j. Past-due/nonaccrual—related information.
  - k. Loan-specific internal problem credit analyses information.
  - l. Loans to insiders and their interests.
  - m. Loans classified during the preceding examination.
7. In analyzing the selected construction loans, the examiner should consider the following procedures, taking appropriate action if necessary:

- a. Determine the primary source of repayment and evaluate its adequacy, including whether—
    - the permanent lender has the financial resources to meet its commitment.
    - the amount of the construction loan and its estimated completion date correspond to the amount and expiration date of the takeout commitment and/or completion bond.
    - the permanent lender and/or the bonding company have approved any modifications to the original agreement.
    - properties securing construction loans that are not supported by a takeout commitment will be marketable upon completion.
  - b. Analyze secondary support afforded by guarantors and partners.
  - c. Relate collateral values to outstanding debt by—

assessing the adequacy of the appraisal and evaluation.

    - ascertaining whether inspection reports support disbursements to date.
    - determining whether the amount of undisbursed loan funds is sufficient to complete the project.
    - establishing whether title records assure the primacy of the bank's liens.
    - determining if adequate hazard, builder's risks, and worker's compensation insurance is maintained.
  - d. Determine whether the loan's loan-to-value (LTV) ratio is in excess of the supervisory LTV limits. If so, ascertain whether the loan has been properly reported as a nonconforming loan.
  - e. Ascertain whether the loan complies with established bank policy.
  - f. Identify any deficiencies in the loan's documentation in both the credit files and the collateral records.
  - g. Identify whether the loan is to an officer, director, or shareholder of the bank or a correspondent bank and whether an officer, director, or shareholder of the bank is a guarantor on the loan.
  - h. Review the borrower's compliance with the provisions of the loan agreement, indicating whether the loan is in default or in past-due status.
  - i. Determine if there are any problems that may jeopardize the repayment of the construction loan.
  - j. Determine whether the loan was classified during the preceding examination, and, if the loan has been paid off, whether all or part of the funds for repayment came from another loan at the bank or from the repossession of the property.
8. In connection with the examination of other lending activity in the bank, the examiner should—
    - a. check the central liability file on the borrower(s) and determine whether the total construction lending activity exceeds the lending limit to a single borrower.
    - b. obtain information and related performance status on common borrowers and their interests from examiners assigned to other examination areas (such as non-real estate loans, leasing, overdrafts, and cash items) and determine the total indebtedness of the borrower to the bank. Additionally, one examiner should be assigned to review the borrower's overall borrowing relationship with the bank.
    - c. perform appropriate procedural steps as outlined in the Concentration of Credits section of this manual. Interim construction loans that do not have firm permanent takeout commitments are to be treated as concentrations of credit.
  9. Consult with the examiner responsible for the asset/liability management analysis portion of the examination to determine the appropriate maturity breakdown of construction loans needed for the analysis and prepare the necessary schedules.
  10. Summarize the findings of the construction loan portfolio review and address—
    - a. the scope of the examination.
    - b. the quality of the policies, procedures, and controls.
    - c. the general level of adherence to policies and procedures.
    - d. the competency of management.
    - e. the quality of the loan portfolio.
    - f. loans not supported by current and complete financial information.
    - g. loans with incomplete documentation, addressing deficiencies related to items such as appraisals or evaluations, feasibility studies, the environmental impact study, takeout commitment, title policy, construction plans, inspection reports, change orders, proof of payment for

- 
- insurance and taxes, deeds of trust, and mortgage notes.
  - h. the adequacy of control over construction draws and advances.
  - i. loans to officers, directors, shareholders, or their interests.
  - j. causes of existing problems.
  - k. delinquent loans and the aggregate amount of statutory bad debts. Refer to the manual section on classification of credits for a discussion on statutory bad debts or A Paper.
  - l. concentrations of credits.
  - m. classified loans.
  - n. violations of laws, regulations, and Federal Reserve policy.
  - o. action taken by management to correct previously noted deficiencies and corrective actions recommended to management at this examination, with the bank's response to such recommendations.

# Real Estate Construction Loans

## Internal Control Questionnaire

Effective date May 2004

## Section 2100.4

Review the bank's internal controls, policies, practices, and procedures for making and servicing real estate construction loans. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Negative responses to the questions in this section should be explained, and additional procedures deemed necessary should be discussed with the examiner-in-charge. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES AND OBJECTIVES

- \*1. Has the board of directors and management, consistent with their duties and responsibilities, adopted and, at least annually, reviewed and approved written construction lending policies that—
  - a. outline construction lending objectives regarding—
    - detail the aggregate limit for construction loans?
    - concentrations of credit in particular types of construction projects?
  - b. establish minimum standards for documentation?
  - c. define qualified collateral and minimum margin requirements?
  - d. define the minimum equity requirement for a project?
  - e. define loan-to-value (LTV) limits that are consistent with supervisory LTV limits?
  - f. require an appraisal or evaluation that complies with the Federal Reserve real estate appraisal regulation and guidelines?
  - g. delineate standards for takeout commitments?
  - h. indicate completion bonding requirements?
  - i. establish procedures for reviewing construction loan applications?
  - j. detail methods for disbursing loan proceeds?
  - k. detail project-inspection requirements and progress-reporting procedures?

- l. require agreements by borrowers for completion of improvements according to approved construction specifications, and cost and time limitations?
- 2. Are construction lending policies and objectives appropriate to the size and sophistication of the bank, and are they compatible with changing market conditions?
- 3. Has the board of directors adopted, and does it periodically review, policies and procedures that establish and maintain an effective, independent real estate appraisal and evaluation program for the entire bank's lending functions? (The real estate lending functions include commercial real estate mortgage departments, capital-market groups, and asset-securitization and -sales units.)

### REVIEWING LOAN APPLICATIONS

- 1. Does bank policy require a personal guarantee from the borrower on construction loans?
- 2. Does bank policy require personal completion guarantees by the property owner and/or the contractor?
- 3. Does the bank require a construction borrower to contribute equity to a proposed project in the form of money or real estate? If so, indicate which form of equity.
- 4. Does the project budget include the amount and source of the builder's and/or owner's equity contribution?
- 5. Does the bank require—
  - a. background information on the borrower's, contractor's, and major subcontractors' development and construction experience, as well as other projects currently under construction?
  - b. payment-history information from suppliers and trade creditors on the aforementioned's previous projects?
  - c. credit reports?
  - d. detailed current and historical financial statements, including cash flow-related information?



6. Do the borrower's project-cost estimates include—
    - a. land and construction costs?
    - b. off-site improvement expenses?
    - c. soft costs, such as organizational and administrative costs, and architectural, engineering, and legal fees?
    - d. interest, taxes, and insurance expenses?
  7. Does the bank require an estimated cost breakdown for each stage of construction?
  8. Does the bank require that cost estimates of more complicated projects be reviewed by qualified personnel: experienced in-house staff, an architect, a construction engineer, or an independent estimator?
  9. Are commitment fees required on approved construction loans?
5. Does the construction loan agreement require that—
    - a. the contractor not start work until authorized to do so by the bank?
    - b. on-site inspections be permitted by the lending officer or an agent of the bank without prior notice?
    - c. disbursement of funds be made as work progresses, supported by documentation that the subcontractors are receiving payment and that the appropriate liens are being released?
    - d. the bank be allowed to withhold disbursements if work is not performed according to approved specifications?
    - e. a percentage of the loan proceeds be retained pending satisfactory completion of the construction?
    - f. the lender be allowed to assume prompt and complete control of the project in the event of default? If a commercial project, are the leases assignable to the bank?
    - g. the contractor carry builder's risk and workers' compensation insurance? If so, has the bank been named as mortgagee or loss payee on the builder's risk policy?
    - h. periodic increases in the project's value be reported to the builder's risk and title insurance companies?
  6. Does the construction loan agreement for residential tract construction loans require—
    - a. bank authorization for individual tract-housing starts?
    - b. that periodic sales reports be submitted to the bank?
    - c. that periodic reports on tract houses occupied under a rental, lease, or purchase-option agreement be submitted to the bank?
    - d. limitations on the number of speculative houses and the completion of one tract before beginning another?

## CONSTRUCTION LOAN AGREEMENTS

1. Is the construction loan agreement signed before an actual loan disbursement is made?
- \*2. Is the construction loan agreement reviewed by counsel and other experts to determine that improvement specifications conform to—
  - a. building codes?
  - b. subdivision regulations?
  - c. zoning and ordinances?
  - d. title and/or ground lease restrictions?
  - e. health and handicap access regulations?
  - f. known or projected environmental protection considerations?
  - g. specifications required under the National Flood Insurance Program?
  - h. provisions in tenant leases?
  - i. specifications approved by the permanent lender?
  - j. specifications required by the completion or performance bonding company and/or guarantors?
- \*3. Does the bank require all change orders to be approved in writing by the—
  - a. bank?
  - b. bank's counsel?
  - c. permanent lender?
  - d. architect or supervising engineer?
  - e. prime tenants bound by firm leases or letters of intent to lease?
  - f. completion bonding company?
4. Does the construction loan agreement set a date for project completion?

## COLLATERAL

1. Are liens filed on non-real estate construction improvements, i.e., personal property that is movable from the project?
2. When entering into construction loans, does the bank, consistent with supervisory loan-to-value limits—

- a. limit the loan amount to a reasonable percentage of the appraised value of the project when there is no prearranged permanent financing?
  - b. limit the loan amount to a percentage of the appraised value of the completed project when subject to the bank's own takeout commitment?
  - c. limit the loan amount to the floor of a takeout commitment that is based upon achieving a certain level of rents or lease occupancy?
3. Are unsecured credit lines to contractors or developers, who are also being financed by secured construction loans, supervised by the construction loan department or the officer supervising the construction loan?
  4. Does the bank have adequate procedures to determine whether construction appraisal or evaluation policies and procedures are consistently being followed in conformance with regulatory requirements, and that the appraisal or evaluation documentation supports the value indicated in the conclusions?
    - c. authorized in writing by the contractor, borrower, inspector, subcontractors, and/or lending officer?
    - d. reviewed by a bank employee who had no part in granting the loan?
    - e. compared with original cost estimates?
    - f. checked against previous disbursements?
    - g. made directly to subcontractors and suppliers?
    - h. supported by invoices describing the work performed and the materials furnished?
  2. Does the bank obtain waivers of subcontractor's and mechanic's liens as work is completed and disbursements are made?
  3. Does the bank obtain sworn and notarized releases of mechanic's liens from the general contractor at the time construction is completed and before final disbursement is made?
  4. Does the bank periodically review undisbursed loan proceeds to determine their adequacy to complete the projects?
  5. Are the borrower's undisbursed loan proceeds and contingency or escrow accounts independently verified at least monthly by someone other than the individuals responsible for loan disbursements?

## INSPECTIONS

1. Are inspection authorities noted in the—
  - a. construction loan commitment?
  - b. construction loan agreement?
  - c. tri-party buy-and-sell agreement?
  - d. takeout commitment?
2. Are inspections conducted on an irregular basis?
3. Are inspection reports sufficiently detailed to support disbursements?
4. Are inspectors rotated from project to project?
5. Are spot checks made of the inspectors' work?
6. Do inspectors determine compliance with plans and specifications as well as the progress of the work? If so, are the inspectors competent to make the determination?

## DISBURSEMENTS

- \*1. Are disbursements—
  - a. advanced on a prearranged disbursement plan?
  - b. made only after reviewing written inspection reports?

## TAKEOUT COMMITMENTS

1. Does counsel review takeout agreements for acceptability?
2. Does the bank obtain and review the permanent lender's financial statements to determine the adequacy of its financial resources to fulfill the takeout commitment?
3. Is a tri-party buy-and-sell agreement signed before the construction loan is closed?
4. Does the bank require takeout agreements to include a force majeure—an act-of-God clause—that provides for an automatic extension of the completion date in the event that construction delays occur for reasons beyond the builder's control?

## COMPLETION BONDING REQUIREMENTS

1. Does the bank require completion insurance for all construction loans?

2. Has the bank established minimum financial standards for borrowers who are not required to obtain completion bonding? Are these standards observed in all cases?
3. Does counsel review completion insurance bonds for acceptability?
3. Does the bank employ standardized checklists to control documentation for individual files, and does it perform audit reviews for adequacy?
4. Does the documentation file indicate all of the borrower's other loans and deposit account relationships with the bank, and include a summary of other construction projects being financed by other banks? Does the bank analyze the status of these projects and the potential effect on the borrower's financial position?

## DOCUMENTATION

1. Does the bank require and maintain documentary evidence of—
  - a. the contractor's payment of—
    - employee withholding taxes?
    - builder's risk insurance?
    - workers' compensation insurance?
    - public liability insurance?
    - completion insurance?
  - b. the property owner's payment of real estate taxes?
2. Does the bank require that documentation files include—
  - a. loan applications?
  - b. financial statements for the—
    - borrower?
    - builder?
    - proposed prime tenant?
    - takeout lender?
    - guarantors/partners?
  - c. credit and trade checks on the—
    - borrower?
    - builder?
    - major subcontractor?
    - proposed tenants?
  - d. a copy of plans and specifications?
  - e. a copy of the building permit?
  - f. a survey of the property?
  - g. the construction loan agreement?
  - h. an appraisal or evaluation and feasibility study?
  - i. an up-to-date title search?
  - j. the mortgage?
  - k. ground leases?
  - l. assigned tenant leases or letters of intent to lease?
  - m. a copy of the takeout commitment?
  - n. a copy of the borrower's application to the takeout lender?
  - o. the tri-party buy-and-sell agreement?
  - p. inspection reports?
  - q. disbursement authorizations?
  - r. undisbursed loan proceeds and contingency or escrow account reconciliations?
  - s. insurance policies?
5. Does the bank use tickler files that—
  - a. control scheduling of inspections and disbursements?
  - b. ensure prompt administrative follow-up on items sent for—
    - recording?
    - an attorney's opinion?
    - an expert review?
6. Does the bank maintain tickler files that provide advance notice (such as 30 days' prior notice) to staff of the expiration dates for—
  - a. the takeout commitment?
  - b. hazard insurance?
  - c. workers' compensation insurance?
  - d. public liability insurance?

## LOAN RECORDS

- \*1. Are the preparation, addition, and posting of subsidiary real estate construction loan records performed or adequately reviewed by persons who do not also—
  - a. issue official checks or drafts?
  - b. handle cash?
  - c. reconcile subsidiary records to general ledger controls?
- \*2. Are the subsidiary real estate construction loan records reconciled at least monthly to the appropriate general ledger accounts? Are reconciling items adequately investigated by persons who do not also handle cash or prepare/post subsidiary controls?
- \*3. Are loan statements, delinquent account-collection requests, and past-due notices reconciled to the real estate construction loan subsidiary records? Are the reconciliations handled by a person who does not also handle cash?
4. Are inquiries about construction loan balances received and investigated by persons who do not also handle cash?

- \*5. Are documents supporting recorded credit adjustments subsequently checked or tested by persons who do not also handle cash?
6. Is a delinquent-accounts report generated daily?
7. Are loans in excess of supervisory LTV limits identified in the bank's records, and are the aggregate amounts of such loans reported at least quarterly to the board of directors?
8. Does the bank maintain a daily record summarizing note transaction details (loans made, payments received, and interest collected) to support applicable general ledger account entries?
9. Are note and liability trial balances frequently reconciled to the general ledger by employees who do not process or record loan transactions?

#### LOAN INTEREST AND COMMITMENT FEES

- \*1. Are the preparation and posting of loan interest and fee records performed or

adequately reviewed by persons who do not also—

- a. issue official checks or drafts?
  - b. handle cash?
2. Are any independent interest and fee computations made and compared with or adequately tested to loan interest by persons who do not also—
    - a. issue official checks or drafts?
    - b. handle cash?

#### CONCLUSION

1. Does the foregoing information provide an adequate basis for evaluating internal control in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
2. On the basis of a composite evaluation, are internal controls adequate as evidenced by answers to the foregoing questions?

# Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices

Effective date May 2007

## Section 2103.1

This interagency supervisory guidance was developed to reinforce sound risk-management practices for institutions with high and increasing concentrations of commercial real estate loans on their balance sheets. The guidance, Concentrations in Commercial Real Estate (CRE) Lending, Sound Risk-Management Practices (the guidance), was issued on December 6, 2006 (effective on December 12, 2006).<sup>1</sup> However, institutions needing to improve their risk-management processes may have been provided the opportunity for some flexibility on the time frame for complying with the guidance. This time frame will be commensurate with the level and nature of CRE concentration risk, the quality of the institution's existing risk-management practices, and its levels of capital. (See 71 *Fed. Reg.* 74,580 [December 12, 2006], the Federal Reserve Board's press release dated December 6, 2006, and SR-07-01 and its attachments.)

### SCOPE OF THE CRE CONCENTRATION GUIDANCE

The guidance focuses on those CRE loans for which the cash flow from the real estate is the primary source of repayment rather than loans to a borrower for which real estate collateral is taken as a secondary source of repayment or through an abundance of caution. For the purposes of this guidance, CRE loans include those loans with risk profiles sensitive to the condition of the general CRE market (for example, market demand, changes in capitalization rates, vacancy rates, or rents). CRE loans are land development and construction loans (including one- to four-family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property, and nonfarm nonresidential property where the primary source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third-party, nonaffiliated, rental income) or the proceeds of

the sale, refinancing, or permanent financing of the property. Loans to real estate investment trusts and unsecured loans to developers also should be considered CRE loans for purposes of this guidance if their performance is closely linked to performance of the CRE markets. The scope of the guidance does *not* include loans secured by nonfarm nonresidential properties where the primary source of repayment is the cash flow from the ongoing operations and activities conducted by the party, or affiliate of the party, who owns the property. Rather than defining a CRE concentration, the guidance's "Supervisory Oversight" section describes the criteria that the Federal Reserve will use as high-level indicators to identify banks potentially exposed to CRE concentration risk.

### CRE CONCENTRATION ASSESSMENTS

Banks that are actively involved in CRE lending should perform ongoing risk assessments to identify CRE concentrations. The risk assessment should identify potential concentrations by stratifying the CRE portfolio into segments that have common risk characteristics or sensitivities to economic, financial, or business developments. A bank's CRE portfolio stratification should be reasonable and supportable. The CRE portfolio should not be divided into multiple segments simply to avoid the appearance of concentration risk.

The Federal Reserve recognizes that risk characteristics vary among CRE loans secured by different property types. A manageable level of CRE concentration risk will vary by bank depending on the portfolio risk characteristics, the quality of risk-management processes, and capital levels. Therefore, the guidance does not establish a CRE concentration limit that applies to all banks. Rather, banks are encouraged to identify and monitor credit concentrations and to establish internal concentration limits, and all concentrations should be reported to senior management and the board of directors on a periodic basis. Depending on the results of the risk assessment, the bank may need to enhance its risk-management systems.

1. The guidance was jointly adopted by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

## CRE RISK MANAGEMENT

The sophistication of a bank's CRE risk-management processes should be appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risk to the bank. Banks should address the following key elements in establishing a risk-management framework that effectively identifies, monitors, and controls CRE concentration risk:

1. board and management oversight
2. portfolio management
3. management information systems
4. market analysis
5. credit underwriting standards
6. portfolio stress testing and sensitivity analysis
7. credit risk review function

### Board and Management Oversight of CRE Concentration Risk

A bank's board of directors has ultimate responsibility for the level of risk assumed by the bank. If the bank has significant CRE concentration risk, its strategic plan should address the rationale for its CRE levels in relation to its overall growth objectives, financial targets, and capital plan. In addition, the Federal Reserve's real estate lending regulations require that each bank adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate, including CRE loans. Therefore, the board of directors or a designated committee thereof should—

1. establish policy guidelines and approve an overall CRE lending strategy regarding the level and nature of CRE exposures acceptable to the bank, including any specific commitments to particular borrowers or property types, such as multifamily housing;
2. ensure that management implements procedures and controls to effectively adhere to and monitor compliance with the bank's lending policies and strategies;
3. review information that identifies and quantifies the nature and level of risk presented by CRE concentrations, including reports that describe changes in CRE market conditions in which the bank lends; and

4. periodically review and approve CRE risk exposure limits and appropriate sublimits (for example, by nature of concentration) to conform to any changes in the bank's strategies and to respond to changes in market conditions.

### CRE Portfolio Management

Banks with CRE concentrations should manage not only the risk of individual loans but also portfolio risk. Even when individual CRE loans are prudently underwritten, concentrations of loans that are similarly affected by cyclical changes in the CRE market can expose a bank to an unacceptable level of risk if not properly managed. Management regularly should evaluate the degree of correlation between related real estate sectors and establish internal lending guidelines and concentration limits that control the bank's overall risk exposure.

Management should develop appropriate strategies for managing CRE concentration levels, including a contingency plan to reduce or mitigate concentrations in the event of adverse CRE market conditions. Loan participations, whole loan sales, and securitizations are a few examples of strategies for actively managing concentration levels without curtailing new originations. If the contingency plan includes selling or securitizing CRE loans, management should assess periodically the marketability of the portfolio. This should include an evaluation of the bank's ability to access the secondary market and a comparison of its underwriting standards with those that exist in the secondary market.

### CRE Management Information Systems

A strong management information system (MIS) is key to effective portfolio management. The sophistication of the MIS will necessarily vary with the size and complexity of the CRE portfolio and level and nature of concentration risk. The MIS should provide management with sufficient information to identify, measure, monitor, and manage CRE concentration risk. This includes meaningful information on CRE portfolio characteristics that is relevant to the bank's lending strategy, underwriting standards, and risk tolerances. A bank should assess periodi-



cally the adequacy of the MIS in light of growth in CRE loans and changes in the CRE portfolio's size, risk profile, and complexity.

Banks are encouraged to stratify the CRE portfolio by property type, geographic market, tenant concentrations, tenant industries, developer concentrations, and risk rating. Other useful stratifications may include loan structure (for example, fixed-rate or adjustable), loan purpose (for example, construction, short-term, or permanent), loan-to-value (LTV) limits, debt service coverage, policy exceptions on newly underwritten credit facilities, and affiliated loans (for example, loans to tenants). A bank should also be able to identify and aggregate exposures to a borrower, including its credit exposure relating to derivatives.

Management reporting should be timely and in a format that clearly indicates changes in the portfolio's risk profile, including risk-rating migrations. In addition, management reporting should include a well-defined process through which management reviews and evaluates concentration and risk-management reports, as well as special ad hoc analyses in response to potential market events that could affect the CRE loan portfolio.

## Market Analysis

Market analysis should provide the bank's management and board of directors with information to assess whether its CRE lending strategy and policies continue to be appropriate in light of changes in CRE market conditions. A bank should perform periodic market analyses for the various property types and geographic markets represented in its portfolio.

Market analysis is particularly important as a bank considers decisions about entering new markets, pursuing new lending activities, or expanding in existing markets. Market information also may be useful for developing sensitivity analysis or stress tests to assess portfolio risk.

Sources of market information may include published research data, real estate appraisers and agents, information maintained by the property taxing authority, local contractors, builders, investors, and community development groups. The sophistication of a bank's analysis will vary by its market share and exposure, as well as the availability of market data. While a bank operating in nonmetropolitan markets may have

access to fewer sources of detailed market data than a bank operating in large, metropolitan markets, a bank should be able to demonstrate that it has an understanding of the economic and business factors influencing its lending markets.

## Credit Underwriting Standards

A bank's lending policies should reflect the level of risk that is acceptable to its board of directors and should provide clear and measurable underwriting standards that enable the bank's lending staff to evaluate all relevant credit factors. When a bank has a CRE concentration, the establishment of sound lending policies becomes even more critical. In establishing its policies, a bank should consider both internal and external factors, such as its market position, historical experience, present and prospective trade area, probable future loan and funding trends, staff capabilities, and technology resources. Consistent with the Federal Reserve's real estate lending guidelines, CRE lending policies should address the following underwriting standards:

1. maximum loan amount by type of property
2. loan terms
3. pricing structures
4. collateral valuation<sup>2</sup>
5. LTV limits by property type
6. requirements for feasibility studies and sensitivity analysis or stress testing
7. minimum requirements for initial investment and maintenance of hard equity by the borrower
8. minimum standards for borrower net worth, property cash flow, and debt service coverage for the property

A bank's lending policies should permit exceptions to underwriting standards only on a limited basis. When a bank does permit an exception, it should document how the transaction does not conform to the bank's policy or underwriting standards, obtain appropriate management approvals, and provide reports to the board of directors or designated committee detailing the number, nature, justifications, and trends for exceptions. Exceptions to both the bank's internal lending standards and the Fed-

2. Refer to the Federal Reserve's appraisal regulations: 12 CFR 208 subpart E and 12 CFR 225, subpart G.

eral Reserve's supervisory LTV limits<sup>3</sup> should be monitored and reported on a regular basis. Further, banks would analyze trends in exceptions to ensure that risk remains within the bank's established risk tolerance limits.

Credit analysis should reflect both the borrower's overall creditworthiness and project-specific considerations as appropriate. In addition, for development and construction loans, the bank should have policies and procedures governing loan disbursements to ensure that the bank's minimum borrower equity requirements are maintained throughout the development and construction periods. Prudent controls should include an inspection process, documentation on construction progress, tracking pre-sold units, pre-leasing activity, and exception monitoring and reporting.

### CRE Portfolio Stress Testing and Sensitivity Analysis

A bank with CRE concentrations should perform portfolio-level stress tests or sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings, and capital. Further, a bank should consider the sensitivity of portfolio segments with common risk characteristics to potential market conditions. The sophistication of stress testing practices and sensitivity analysis should be consistent with the size, complexity, and risk characteristics of the CRE loan portfolio. For example, well-margined and seasoned performing loans on multifamily housing normally would require significantly less robust stress testing than most acquisition, development, and construction loans.

Portfolio stress testing and sensitivity analysis may not necessarily require the use of a sophisticated portfolio model. Depending on the risk characteristics of the CRE portfolio, stress testing may be as simple as analyzing the potential effect of stressed loss rates on the CRE portfolio, capital, and earnings. The analysis should focus on the more vulnerable segments of a bank's CRE portfolio, taking into consideration the prevailing market environment and the bank's business strategy.

3. The Interagency Guidelines for Real Estate Lending state that loans exceeding the supervisory LTV guidelines should be recorded in the bank's records and reported to the board at least quarterly.

### Credit Risk Review Function

A strong credit risk review function is critical for a bank's self-assessment of emerging risks. An effective, accurate, and timely risk-rating system provides a foundation for the bank's credit risk review function to assess credit quality and, ultimately, to identify problem loans. Risk ratings should be risk sensitive, objective, and appropriate for the types of CRE loans underwritten by the bank. Further, risk ratings should be reviewed regularly for appropriateness.

### SUPERVISORY OVERSIGHT OF CRE CONCENTRATION RISK

As part of its ongoing supervisory monitoring processes, the Federal Reserve will use certain criteria to identify banks that are potentially exposed to significant CRE concentration risk. A bank that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

1. total reported loans for construction, land development, and other land<sup>4</sup> represent 100 percent or more of the bank's total capital<sup>5</sup> or
2. total commercial real estate loans as defined in this guidance<sup>6</sup> represent 300 percent or more of the bank's total capital, and the outstanding balance of the bank's commercial real estate loan portfolio has increased by 50 percent or more during the prior 36 months.

The Federal Reserve will use the criteria as a preliminary step to identify banks that may have CRE concentration risk. Because regulatory reports capture a broad range of CRE loans with varying risk characteristics, the

4. For commercial banks as reported in the Call Report FFIEC 031 and 041, schedule RC-C, item 1a.

5. For purposes of this guidance, the term *total capital* means the total risk-based capital as reported for commercial banks in the Call Report FFIEC 031 and 041 schedule RC-R—Regulatory Capital, line 21.

6. For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC-C, items 1a, 1d, 1e, and memorandum item 3.



supervisory monitoring criteria do not constitute limits on a bank's lending activity but rather serve as high-level indicators to identify banks potentially exposed to CRE concentration risk. Nor do the criteria constitute a "safe harbor" for banks if other risk indicators are present, regardless of their measurements under (1) and (2).

## Evaluation of CRE Concentrations

The effectiveness of a bank's risk-management practices will be a key component of the supervisory evaluation of the bank's CRE concentrations. Examiners will engage in a dialogue with the bank's management to assess CRE exposure levels and risk-management practices. Banks that have experienced recent, significant growth in CRE lending will receive closer supervisory review than those that have demonstrated a successful track record of managing the risks in CRE concentrations.

In evaluating CRE concentrations, the Federal Reserve will consider the bank's own analysis of its CRE portfolio, including consideration of factors such as—

1. portfolio diversification across property types
2. geographic dispersion of CRE loans
3. underwriting standards
4. level of pre-sold units or other types of take-out commitments on construction loans

5. portfolio liquidity (ability to sell or securitize exposures on the secondary market)

While consideration of these factors should not change the method of identifying a credit concentration, these factors may mitigate the risk posed by the concentration.

## Assessment of Capital Adequacy for CRE Concentration Risk

The Federal Reserve's existing capital adequacy guidelines note that a bank should hold capital commensurate with the level and nature of the risks to which it is exposed. Accordingly, banks with CRE concentrations are reminded that their capital levels should be commensurate with the risk profile of their CRE portfolios. In assessing the adequacy of a bank's capital, the Federal Reserve will consider the level and nature of inherent risk in the CRE portfolio as well as management expertise, historical performance, underwriting standards, risk-management practices, market conditions, and any loan loss reserves allocated for CRE concentration risk. A bank with inadequate capital to serve as a buffer against unexpected losses from a CRE concentration should develop a plan for reducing its CRE concentrations or for maintaining capital appropriate to the level and nature of its CRE concentration risk.

# Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices

## Examination Objectives

Effective date October 2007

## Section 2103.2

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When a bank has significant commercial real estate (CRE) credit concentrations, the inspection objectives are as follows:

1. To determine if the bank's risk-management practices and capital levels are commensurate with the level and nature of its CRE concentration risk.
2. To ascertain if the bank performs ongoing risk assessments to identify its CRE concentrations.
3. To evaluate whether the bank's CRE risk-management processes are appropriate for the size of its CRE loan portfolio, as well as for the level and nature of its concentrations and their associated risks to the bank.
  - a. To determine whether the bank's strategic plan addresses the rationale for its CRE credit concentration levels in relation to its overall growth objectives, financial targets, and capital plan.
  - b. To evaluate whether the bank manages not only the risk of individual loans but also its loan portfolio risks.
  - c. To find out if the bank's management information system provides management with sufficient information that can be used to identify, measure, and manage the bank's CRE concentration risk.
- d. To verify whether the bank's market analyses provide the bank's management and board of directors with sufficient information to assess whether the bank's CRE lending strategy and policies continue to be appropriate in light of its changing CRE market conditions.
4. To determine if the bank's CRE lending policies reflect the level of credit risk that is acceptable to its board of directors.
  - a. To evaluate whether the lending policies provide clear and measurable underwriting standards.
  - b. To assess whether the bank's lending policies enable the bank's lending staff to evaluate all relevant credit factors.
5. To find out if the bank performs portfolio-level stress tests or sensitivity analyses in order to quantify the impact of changing economic conditions on asset quality, earnings, and capital.
6. To determine if the bank has a strong credit-review function that includes a self-assessment of its emerging credit and other risks.

# Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices

## Examination Procedures

Effective date October 2007

## Section 2103.3

### RISK MANAGEMENT

#### Board and Senior Management Oversight

1. Determine if the board of directors or its designated committee has—
  - a. established policy guidelines and approved an overall commercial real estate (CRE) lending strategy on the level and nature of the bank's CRE exposures, including any specific commitments to particular borrowers or property types, such as multifamily housing;
  - b. ensured that management implements procedures and controls to effectively adhere to and monitor compliance with the bank's lending policies and strategies;
  - c. reviewed information that identifies and quantifies the nature and level of risk presented by CRE concentrations, including a review of reports that describe changes in the CRE market conditions in which the bank lends; and
  - d. periodically reviewed and approved CRE risk exposure limits and appropriate sub-limits (for example, by nature of concentration) to ensure they conform to any changes in the bank's strategies and respond to changes in market conditions.

#### Supervisory Oversight

2. Determine if the bank is (or is potentially) exposed to significant CRE credit concentration risk.
3. If the bank has experienced rapid growth in CRE lending or has notable exposure to a specific type of CRE, or if the bank is approaching or exceeds one or both of the following criteria, perform a preliminary analysis of the bank's CRE concentration risk:
  - a. Total loans for construction, land development, and other land represent 100 percent or more of the bank's total capital.
  - b. Total CRE loans represent 300 percent or more of the bank's total capital, and the

outstanding balance of the bank's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

#### Portfolio Management

4. Ascertain whether the bank manages not only the risk from individual loans but also portfolio risk. Find out if management—
  - a. regularly (1) evaluates the degree of correlation between related real estate sectors and (2) establishes internal lending guidelines and concentration limits that control the bank's overall risk exposure; and
  - b. develops appropriate strategies for managing CRE concentration levels, including the development of a contingency plan to reduce or mitigate concentrations during adverse CRE market conditions (such a plan may include strategies involving loan participations, whole loan sales, and securitizations).
    - Find out if the bank's contingency plan includes selling or securitizing CRE loans.
    - Ascertain if management periodically assesses the marketability of the CRE portfolio and evaluates the bank's ability to access the secondary market.
    - Verify whether the bank compares its underwriting standards with those that exist in the secondary market.

#### Management Information Systems

5. Evaluate whether management information systems (MIS) provide sufficient information to identify, measure, monitor, and manage CRE concentration risk (MIS should include information on CRE portfolio characteristics that are consistent with and relevant to the bank's lending strategy, underwriting standards, and risk tolerances).
6. Verify that management reporting is timely and in a format that clearly indicates changes in the portfolio's risk profile, including risk-rating migrations.

## Market Analysis

7. Determine if management reporting includes a well-defined process through which management reviews and evaluates concentration and risk-management reports, as well as special ad hoc analyses that are prepared in response to potential market events that could affect the CRE loan portfolio.
8. Find out if the bank's market analysis provides management and the board of directors with sufficient information to assess (1) the bank's CRE lending strategy and policies and (2) whether they continue to be appropriate in light of changes in CRE market conditions.

## Credit-Underwriting Standards

9. Determine if CRE lending policies include the following underwriting standards:
  - a. maximum loan amount by type of property
  - b. loan terms
  - c. pricing structures
  - d. collateral valuation
  - e. loan-to-value (LTV) limits by property type
  - f. requirements for feasibility studies and sensitivity analyses or stress testing
  - g. minimum requirements for initial investment and maintenance of hard equity by the borrower
  - h. minimum standards for borrower net worth, property cash flow, and debt-service coverage for the property
10. Review the bank's permitted exceptions to its underwriting standards. Ascertain if the exceptions—
  - a. have been granted on a limited basis only; and
  - b. are supported by documentation and reports to management and the board of directors or a designated committee. The documentation and reports should indicate—
    - how the transactions did not conform to the bank's policy or underwriting standards;
    - whether appropriate management approvals were obtained; and
    - the details of the number and nature of and the justifications and trends for the exceptions.

11. Verify that exceptions to both the bank's internal lending standards and the Federal Reserve's supervisory LTV limits are monitored and reported on a regular basis.
12. Find out if the bank analyzes trends in its CRE lending exceptions in order to ensure that credit-underwriting risk remains within its established risk-tolerance limits.
13. Evaluate whether the bank's credit analyses reflect both the borrowers' overall credit-worthiness and project-specific considerations, as appropriate.
14. For the bank's development and construction loans, determine if—
  - a. the bank has policies and procedures governing loan disbursements in order to ensure that the bank's requirements for minimum borrower equity are maintained throughout the development and construction periods; and
  - b. prudent controls, including the following, are in place:
    - an inspection process
    - documentation of construction progress
    - tracking of pre-sold units
    - pre-leasing activity
    - exception monitoring and reporting

## Portfolio Stress Testing and Sensitivity Analysis

15. When the bank has CRE concentrations, determine if it performs portfolio-level stress tests or sensitivity analyses in order to quantify the impact of changing economic conditions on asset quality, earnings, and capital.
  - a. Ascertain if the bank considers the sensitivity of portfolio segments with common risk characteristics to potential market conditions.
  - b. Determine whether the sophistication of the bank's stress-testing practices and sensitivity analyses are consistent with the size, complexity, and risk characteristics of its CRE loan portfolio.
  - c. Evaluate whether the bank's sensitivity analyses focus on the more vulnerable segments of its CRE portfolio, considering its prevailing market environment and business strategy.

### Credit-Review Function

16. Find out if the bank has a credit-review function, and if it is supported by a credit-risk rating system that is used to assess credit quality and identify problem loans.
17. Determine if (1) the bank's risk ratings are risk-sensitive, objective, and appropriate for the types of CRE loans underwritten and (2) the risk ratings are regularly reviewed.

### EVALUATION OF CRE CONCENTRATIONS

1. Engage in a dialogue with bank management in order to assess the bank's CRE exposure levels and risk-management practices. If the bank has experienced recent, significant growth in CRE lending, perform an expanded review of the bank's risk in CRE concentrations, including a review of the bank's analysis of its CRE concentrations. Consider factors such as—
  - a. portfolio diversification across property types
  - b. the geographic dispersion of CRE loans
  - c. underwriting standards

- d. the level of pre-sold units or other types of take-out commitments on construction loans
- e. portfolio liquidity (the ability to sell or securitize exposures on the secondary market)

### Assessment of Capital Adequacy

2. Evaluate whether the bank's holds capital commensurate with the risk profile of its CRE portfolios. Consider the level and nature of inherent risk in the bank's CRE portfolio, as well as management expertise, historical performance, underwriting standards, risk-management practices, market conditions, and any loan-loss reserves allocated for CRE concentration risk.
3. If a bank has inadequate capital to serve as a buffer against unexpected losses from its CRE concentration, reach agreement with the bank's senior management and board of directors on the development of a plan to reduce the bank's CRE concentrations or to maintain capital that is appropriate and commensurate with the level and nature of the bank's CRE concentration risk.

# Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices

## Internal Control Questionnaire

Effective date October 2007

Section 2103.4

### CRE CONCENTRATION ASSESSMENTS

1. Are ongoing risk assessments performed to identify commercial real estate (CRE) concentrations?
2. Are CRE concentration limits established and monitored?
3. Is the CRE portfolio stratified into reasonable and supportable segments that have common risk characteristics or sensitivities to economic, financial, or business developments?
4. Are all CRE concentrations reported to senior management and the board of directors on a periodic basis?

### RISK MANAGEMENT

1. Has a risk-management framework been established that effectively identifies, monitors, and controls CRE concentration risk? If such a framework has been established, does it address—
  - a. board and management oversight?
  - b. portfolio management?
  - c. management information systems?
  - d. market analysis?
  - e. credit-underwriting standards?
  - f. portfolio stress testing and sensitivity analysis?
  - g. the credit-risk review function?

### Board and Management Oversight

2. If the bank has significant CRE concentration risk, does it have a strategic plan that addresses the rationale for its CRE concentration levels in relation to the bank's overall growth objectives, financial targets, and capital plan?
3. Has the board of directors or its designated committee—
  - a. established policy guidelines and approved an overall CRE lending strategy for the level and nature of CRE exposures, including any specific com-

mitments to particular borrowers or property types, such as multifamily housing?

- b. ensured that the bank's management implements procedures and controls to effectively adhere to and monitor compliance with the bank's lending policies and strategies?
- c. reviewed information that identifies and quantifies the nature and level of risk presented by CRE concentrations, including a review of reports that describe changes in the conditions of the CRE market in which the bank lends?
- d. periodically reviewed and approved CRE risk exposure limits and appropriate sublimits (for example, by nature of concentration) in order to conform to any changes in the bank's strategies and respond to changes in market conditions?

### Portfolio Management

4. Does the bank's management regularly perform an analysis of its CRE portfolio, considering factors such as—
  - a. portfolio diversification across property types?
  - b. the geographic dispersion of CRE loans?
  - c. underwriting standards?
  - d. the level of pre-sold units or other types of take-out commitments on construction loans?
  - e. portfolio liquidity (the ability to sell or securitize exposures on the secondary market)?
5. Has the bank's board of directors and senior management—
  - a. (1) regularly evaluated the degree of correlation between related real estate sectors and (2) established internal lending guidelines?
  - b. established internal lending guidelines and concentration limits in order to control the bank's overall risk exposure?
  - c. developed appropriate strategies to manage CRE concentration levels?
6. Has the bank's management developed a

contingency plan to reduce or mitigate CRE loan concentrations during adverse market conditions? If the bank's contingency plan includes selling or securitizing CRE loans, has management periodically assessed the marketability of the portfolio?

## Management Information System

7. Does the bank's management information system (MIS) provide sufficient information to identify, monitor, and manage CRE concentration risk?
8. Is the bank's CRE portfolio stratified by property type, geographic market, tenant concentrations, tenant industries, developer concentrations, and risk rating?
9. Does the bank's MIS identify and aggregate exposures to a borrower, including its credit exposure relating to derivatives?
10. Are the bank's management reports timely and in a format that clearly indicates changes in the portfolio's risk profile?
11. Does the bank's management reporting include a well-defined process whereby management reviews and evaluates CRE concentrations, risk-management reports, and special ad hoc analyses prepared in response to potential market events that could affect the concentration risk in the bank's CRE portfolio?

## Credit-Underwriting Standards

12. Are underwriting standards clear and measurable, and do they enable the bank's lending staff to evaluate relevant credit factors?
13. Do the bank's CRE lending policies address the following underwriting standards—
  - a. maximum loan amount by type of property?
  - b. loan terms?
  - c. pricing structures?
  - d. collateral valuation?
  - e. loan-to-value (LTV) limits by property type?
  - f. requirements for feasibility studies and sensitivity analyses or stress testing?
  - g. minimum requirements for initial invest-

ment and maintenance of hard equity by the borrower?

- h. minimum standards for borrower net worth, property cash flow, and debt-service coverage for the property?
14. Do the bank's lending policies permit exceptions to its underwriting standards for CRE concentrations on a limited basis only?
15. Are permitted exceptions documented; that is, do the documented exceptions describe how the loan transaction does not conform to the bank's lending policy or underwriting standards?
16. Does management analyze trends in exceptions to ensure that the bank's CRE concentration risk remains within established risk-tolerance limits?
17. Does the bank have policies and procedures governing loan disbursements in order to ensure that its minimum requirements for borrower equity are maintained throughout development and construction periods?
18. Do the bank's internal controls consist of an inspection process, documentation on construction progress, tracking of pre-sold units, tracking of pre-leasing activity, and exception monitoring and reporting?

## Portfolio Stress Testing and Sensitivity Analysis

19. Are portfolio stress tests or sensitivity analyses performed in order to quantify the impact of changing economic conditions on asset quality, earnings, and capital?
20. If performed, are portfolio stress tests or sensitivity analyses required to focus on the more vulnerable segments of the bank's CRE portfolio? Do they take into consideration the prevailing market environment and the bank's business strategy?

## Credit-Review Function

21. Does the bank have an effective, accurate, and timely risk-rating system that supports its credit-review function?
22. Are credit-risk ratings reviewed regularly for appropriateness?

### INTRODUCTION

Floor-plan lending is a form of dealer-inventory financing in which each loan advance, which may be as much as 100 percent of the dealer's invoiced cost, is collateralized by a specific piece of inventory. As each unit of inventory is sold by the dealer, the loan advance against that unit of inventory is repaid. Floor-planned items typically have broad consumer demand. Items commonly subject to floor-plan debt are automobiles, large home appliances, furniture, televisions and stereo equipment, boats, mobile homes, and other types of merchandise usually sold under a sales-finance contract. Floor-plan financing involves all the basic risks inherent in any form of inventory financing. However, because of the high loan-to-value ratios typical of floor-plan financing, the exposure to loss is generally greater than in other types of inventory financing.

### COLLATERAL

As with all inventory financing, collateral value is of prime importance. Control over collateral value requires the bank to determine the value at the time the loan is placed on the books, to periodically inspect the collateral to determine its condition and location, and to determine whether any curtailment payments<sup>1</sup> are needed to keep the loan balance in line with depreciating collateral values. As a general rule, curtailment payments are not required for new automobile models until the model year is approximately one-half over. Periodic curtailment payments are then expected to commence at some predetermined percentage of the amount financed.

### Collateral Inspections

The examiner should determine whether the bank is inspecting the collateral frequently and

thoroughly enough to ensure compliance with the floor-plan agreement. Inspections should be conducted on a surprise basis. Floor-plan inspection reports should be reviewed and retained by the bank. Where practical, inspection duties should be rotated among the bank's staff. Banks should verify the floor-planned inventory by comparing serial numbers with manufacturers' certificates of origin or titles and to the bank's records, and the inspection reports should reflect whether the floor-planned inventory is available for sale. Any missing inventory or other exceptions revealed by the inspection, and the dealer's explanation, should be noted in the inspection report.

### SECURITY INTEREST

In most banks, the security interest to floor-planned inventory is evidenced by a trust receipt.<sup>2</sup> Generally, trust receipts are created by two methods. First, the bank may enter into a drafting agreement with the manufacturer, which is similar to a letter of credit. In this situation, the bank agrees to pay documentary drafts covering shipments of merchandise to the dealer. The drafts are payable at the time the merchandise is received by the dealer or, if the manufacturer permits, after a grace period, which allows the dealer to prepare the inventory for sale. The drafting agreement usually limits the number of units, the per-unit cost, and the aggregate cost that can be shipped at one time. Drafting agreements are frequently used in conjunction with repurchase agreements when the manufacturer agrees to repurchase inventory that remains unsold after a specified period of time. The inventory and related title documents remain with the dealer until they are sold and are evidenced by a trust receipt. Banks should physically inspect all the documents during the floor-plan inspection to prevent dual financing.

Second, trust receipts are also created when merchandise is shipped under an invoice sys-

1. Curtailment payments are payments made by the dealer to the floor-plan lender when an item of floor-planned inventory is not sold during the anticipated time frame. The implicit assumption is that if the floor-planned inventory is not sold as anticipated, the inventory value depreciates over time. Unless a curtailment payment is made, the bank's loan-to-value ratio would increase and place the bank in a riskier position than desired.

2. A trust receipt is a document issued to the floor-plan lender by the dealer receiving the floor-plan financing. The trust receipt provides evidence that the dealer possesses the floor-planned inventory. It establishes the bank's rights to the inventory collateral and its proceeds or refers to other documents that set forth the rights of the bank.



tem. The dealer receives the inventory accompanied by invoices and titles, where appropriate. The dealer presents the documents to the bank and the bank pays the invoice, attaching duplicates of the documents to a trust receipt that is signed by the borrower. Depending on the type of inventory and the dealer, the title may remain in the bank or be released. For example, used car inventories are usually financed with trust receipts listing each item of the inventory and its loan value.

The method of perfecting a security interest varies from state to state, and there can be divergences from the Uniform Commercial Code. The examiner should determine that the security interest has been properly perfected. For a detailed discussion of the UCC requirements regarding secured transactions, refer to section 2080.1, "Commercial and Industrial Loans."

## BANK/DEALER RELATIONSHIP

Two important facets of the bank's relationship with a dealer are (1) the quality of the paper generated and (2) the deposit account maintained. The income derived from a floor-plan loan may not be sufficient to justify the credit risk. However, additional income derived from quality loans to purchasers of the dealer's inventory may justify the credit risk. If the bank is not receiving an adequate portion of loans generated by the dealer or if the paper is of inferior quality, the relationship is of questionable value to the bank. The dealer's deposit relationship represents both a compensating balance and a tool by which the loan officer can monitor customer activity. A review of the flow of funds into and out of the dealer's account may suggest that inventory has been sold without debt reduction, that the dealer is incurring abnormal expenses, or that unreported diversification, expansion, or other financial activity has occurred that might warrant a reconsideration of the credit arrangement. Token or overdrawn balances should also trigger increased attention to the value of the relationship.

## DEALER FINANCIAL ANALYSIS

Many dealers have minimal liquidity and capital relative to total debt. Therefore, the bank should closely and frequently review the dealer's finan-

cial information. Annual and interim financial statements are necessary to monitor the dealer's condition. Interim financial statements are often in the form of monthly financial reports to the dealer's franchiser. In analyzing the data, the bank should review the number of units sold and the profitability of those sales, as well as compare the number of units sold with the number financed to determine that inventory levels are reasonable.

Inventory will invariably be a dealer's primary asset, and its acquisition will normally create the dealer's major liability. The dealer's financial statement should show an inventory figure at least equal to the related flooring liability. Unless the difference is represented by short-term sales receivables, including contracts in transit, a floor-plan liability that is greater than the amount of inventory is an indication that the dealer has sold inventory and has not made the appropriate loan payment. To assess credit quality, it is essential that the examiner closely evaluate the level of floor-plan debt relative to inventory.

## IDENTIFYING PROBLEMS

Missing inventory, reportedly sold and unpaid, should be verified to related contracts-in-process. Time to collect on contracts-in-process should be reasonable and conform to the floor-plan agreement. Floor-planned inventory sold and *not* in the process of payment is termed "sold out of trust" and represents a breach of trust by the dealer—and a significant exposure to the bank.

During floor-plan inspections, recurring out-of-trust positions that are not cleared in a reasonable time frame (three to five days) should be a red flag. If a bank discovers that a dealer is deliberately withholding funds or diverting funds received from the sale of pledged inventory, bank officials should meet with the borrower to discuss this situation and, if appropriate, consider terminating the lending relationship. Banks should avoid complicated situations in which they finance only part of the dealer's floor-plan debt that originates from one particular manufacturer or distributor. Other warning signs banks should be aware of include interest or curtailment payment delinquencies, extended maturities beyond reasonable expectations, slow-moving inventory, and the absence of interim financial statements.

## LOAN POLICY

The bank's loan policy should establish sound standards to control the credit and operational risks associated with floor-plan lending. At a minimum, the policy should address the need

for detailed tri-party (manufacturer, dealer, and banker) floor-plan agreements, loan-to-value requirements, the percentage amount and timing of curtailment payments, inspection standards, and the frequency for obtaining and evaluating financial statements.

# Floor-Plan Loans

## Examination Objectives

Effective date May 1996

## Section 2110.2

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1. To determine if policies, practices, procedures, and internal controls for floor-plan loans are adequate.
2. To determine if bank officers are conforming to established guidelines.
3. To evaluate the quality of the loan portfolio and the sufficiency of its collateral.
4. To determine the scope and effectiveness of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

# Floor-Plan Loans

## Examination Procedures

Effective date November 2003

## Section 2110.3

1. If selected for implementation, complete or update the floor-plan loans section of the internal control questionnaire.
2. On the basis of the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal or external auditors from the examiner assigned to internal control, and determine if corrections have been accomplished.
4. Request that the bank supply the following:
  - a. schedule of curtailment requirements for each dealer
  - b. schedule of approved floor-plan lines for each dealer, including outstanding balances
  - c. delinquent curtailment billing report
  - d. drafting agreements and amount of outstanding drafts
  - e. delinquent interest billings, date billed, and amount of past-due interest
5. Obtain a trial balance of all floor-plan accounts.
  - a. Agree balances to department controls and general ledger.
  - b. Review reconciling items for reasonableness.
6. Using an appropriate technique, select borrowers for examination.
7. Using the trial balance, transcribe the following information for each borrower selected onto the credit line cards:
  - a. total outstanding liability
  - b. number of items
  - c. status of any outstanding interest or curtailment billings
  - d. amount of approved floor-plan line
8. Obtain liability and other information on common borrowers from examiners assigned to overdrafts, lease financing, and other loan areas, and together decide who will review the borrowing relationship.
9. Obtain from the bank or appropriate examiner the following schedules, if applicable to this area:
  - a. past-due loans
  - b. loans in a nonaccrual status
  - c. loans on which interest is not being collected in accordance with the terms of the loan (Particular attention should be given to loans that have been renewed with interest being rolled into principal.)
  - d. loans whose terms have been modified by a reduction on interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms
  - e. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
  - f. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
  - g. loan commitments and other contingent liabilities
  - h. extensions of credit to employees, officers, directors, and principal shareholders and their interests specifying which officers are considered executive officers
  - i. extensions of credit to executive officers, directors, and principal shareholders and their interests of correspondent banks
  - j. a list of correspondent banks
  - k. miscellaneous loan-debit and credit-suspense accounts
  - l. loans considered "problem loans" by management
  - m. specific guidelines in the lending policy
  - n. each officer's current lending authority
  - o. current interest-rate structure
  - p. any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee
  - q. reports furnished to the loan and discount committee or any similar committee
  - r. reports furnished to the board of directors
  - s. loans classified during the previous examination
10. Review the information received, and perform the following procedures.
  - a. *Loans transferred, either in whole or in part, to or from another lending institu-*

tion as a result of a participation, sale or purchase, or asset swap.

- Participations only:
    - Test participation certificates and records, and determine that the parties share in the risks and contractual payments on pro rata basis.
    - Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
  - Procedures pertaining to *all* transfers:
    - Investigate any situations in which loans were transferred immediately before the date of examination to determine if any were transferred to avoid possible criticism during the examination.
    - Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
    - Determine that low-quality loans transferred to (but not purchased) or from the bank are properly reflected on its books at fair market value (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium). Section 23A of the Federal Reserve Act prohibits a state member bank from purchasing low-quality assets.
    - Determine that low-quality loans transferred to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.
    - If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
      - (1) name of originating institution
      - (2) name of receiving institution
      - (3) type of transfer (i.e., participation, purchase or sale, swap)
      - (4) date of transfer
      - (5) total number of loans transferred
      - (6) total dollar amount of loans transferred
      - (7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
      - (8) any other information that would be helpful to the other regulator
  - b. *Miscellaneous loan-debit and credit-suspense accounts.*
    - Discuss with management any large or old items.
    - Perform additional procedures as deemed appropriate.
  - c. *Loans classified during the previous examination.* Determine the disposition of loans so classified by reviewing—
    - current balances and payment status,
    - date loan was repaid and sources of payment, and
    - any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank, or as a result of a participation, sale, or swap with another lending institution. If repayment was a result of a participation, sale or swap, refer to step 10a of this section for the appropriate examination procedures.
  - d. *Loan commitments and other contingent liabilities.* Analyze whether—
    - the borrower has been advised of the contingent liability, and
    - the combined amounts of the current loan balance and the commitment or contingent liability exceeds the cutoff.
  - e. Select loans that require in-depth review on the basis of the information derived from the above schedules.
11. Consult with the examiner responsible for the asset/liability management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources. See “Instructions for the Report of Exami-

- nation,” section 6000.1, for considerations to be taken into account when compiling maturity information for the gap analysis.
12. For those loans selected in step 6 and for any other loans selected while performing the above steps—
    - a. transcribe the following information from the bank’s collateral record onto the credit line card:
      - a list of items floored, including date of entry, description of property, amount advanced, and curtailment, if any (Similar items and model year should be shown in aggregate, and entry dates should be shown as a range, except on stale or not properly curtailed items.)
      - a summary of the wholesale agreement between the bank and the dealer
      - a summary of the agreement between the manufacturer and the bank
      - a summary of any repurchase agreement
      - evidence that security interest has been perfected
      - details of any guarantees that may be held
      - details of any other collateral held
    - b. review the two most recent floor-plan inspection reports and determine—
      - if any items were sold out of trust,
      - that where trust receipts were used, all title documents were physically inspected, and
      - that appropriate follow-up was made on all missing items.
  13. Determine compliance with laws and regulations pertaining to floor-plan loans by performing the following steps.
    - a. *Lending limits.*
      - Determine the bank’s lending limits as prescribed by state law.
      - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    - b. *18 USC 215, Commission or Gift for Procuring Loan.*
      - While examining the floor-plan loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
      - Investigate any such suspected situation.
    - c. *12 USC 1972, Tie-In Provisions.* While reviewing credit and collateral files (especially loan agreements), determine whether any extension of credit is conditioned upon—
      - obtaining or providing an additional credit, property, or service to or from the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service, or
      - the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit.
    - d. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows (the examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment):
      - *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Interests.* While reviewing information relating to insiders that is received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps)—
        - test the accuracy and completeness of information about floor-plan loans by comparing it with the trial balance or loans sampled;
        - review credit files on insider loans to determine that required information is available;
        - determine that loans to insiders do not contain terms more favorable than those afforded other borrowers;
        - determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features;
        - determine that loans to insiders, as defined by the various sections of Regulation O, do not exceed the

- lending limits imposed by those sections;
- if prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained;
  - determine compliance with the various reporting requirements for insider loans;
  - determine that the bank has made provisions to comply with the public disclosure requirements for insider loans; and
  - determine that the bank maintains records of public disclosure requests and the disposition of the requests for a period of two years after the date of the requests.
- *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
    - Obtain from or request that the examiners reviewing due from banks and deposit accounts verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
    - Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.
14. Perform the appropriate procedural steps in "Concentrations of Credit," section 2050.3.
  15. Discuss with appropriate officers, and prepare summaries in appropriate report form for—
    - a. delinquent loans;
    - b. extensions of credit to employees, officers, directors, and/or their interests;
    - c. loans on which collateral documentation is deficient;
    - d. transfers of low-quality loans to or from another lending institution;
    - e. the adequacy of written policies relating to floor-plan loans;
    - f. the manner in which bank officers are conforming with established policy;
    - g. schedules applicable to the department that were discovered to be incorrect or incomplete;
    - h. the performance of departmental management;
    - i. internal control deficiencies or exceptions;
    - j. recommended corrective action when policies, practices, or procedures are deficient; and
    - k. other matters of significance.
  16. Update the workpapers with any information that will facilitate future examinations.

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

### **POLICIES**

1. Has the board of directors, consistent with its duties and responsibilities, adopted written floor plan loan policies that:
  - a. Establish procedures for reviewing floor plan applications?
  - b. Define qualified borrowers, overall limits, and types of merchandise to be floor planned?
  - c. Establish minimum standards for documentation?
  - d. Establish curtailment amounts and time limits?
2. Are floor plan loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

### **RECORDS**

- \*3. Is the preparation and posting of subsidiary floor plan loan records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
4. Are the subsidiary floor plan loan records reconciled daily with the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?
- \*5. Are delinquent account collection requests and past-due notices checked to the trial balances used in reconciling floor plan subsidiary records with general ledger accounts, and are they handled only by persons who do not also handle cash?
- \*6. Are inquiries about loan balances received and investigated by persons who do not also handle cash?

- \*7. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash (if so, explain briefly)?
8. Is a daily record maintained summarizing note transaction details, i.e., loans made, payments received and interest collected, to support applicable general ledger account entries?
9. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?
10. Is an overdue account report generated frequently (if so, state frequency \_\_\_\_\_)?

### **LOAN INTEREST**

- \*11. Is the preparation and posting of interest records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts singly?
  - b. Handle cash?
12. Are any independent interest computations made and compared or adequately tested to initial interest records by persons who do not also:
  - a. Issue official checks or drafts singly?
  - b. Handle cash?

### **COLLATERAL**

13. Are floor plan checks, physical inventories, conducted at least monthly and on a surprise basis (if so, state frequency \_\_\_\_\_)?
14. Are more frequent floor plan checks required if the dealer is experiencing financial difficulties?
15. Are individuals performing floor plan checks rotated?
16. Are floor plan inspector(s) required to determine or verify the following and indicate their findings on the floor plan check sheet:
  - a. Serial number of item?
  - b. Odometer reading of vehicles?
  - c. Condition of item?



- d. Location of item, if other than normal place of business?
- e. Existence of any fire or theft hazards?
17. Does the floor plan inspector include on the check sheet:
  - a. Date inspection was performed?
  - b. Date any item located elsewhere was checked?
  - c. His or her signature?
  - d. Summary of his or her report, if appropriate?
18. Are all demonstrators checked?
19. Are floor plan reports reviewed by an officer?
20. Are follow-up inspections made of items not seen during the regular inspection?
21. Are items reported by the dealer as being sold, required to be paid off immediately?
22. Does the floor plan inspector determine the date that item(s) reported as sold were sold from that on the dealer's copy of the sales agreement?
23. Are dealer sales patterns reviewed to determine that the number of units reported sold at the time of floor plan inspection is not excessive and does not indicate a float?
24. Are payments-in-process reported by the dealer during floor plan inspection verified by bank personnel?
25. When a dealer trade or "swap" occurs, does the bank:
  - a. Obtain the manufacturer's invoice from the selling dealer on the new unit acquired?
  - b. Obtain the invoice from the borrowing dealer for the new unit?
  - c. Have a trust receipt executed on the new unit?
26. Does the bank have a procedure to check all indirect paper received from a dealer against the trust receipts of items floored for that dealer to determine that there is no duplication of loans against the same security?
27. Does the bank have floor plan property damage insurance or require that the dealer maintain such coverage with the bank named as loss payee?
28. Is the insurance coverage periodically reviewed for adequacy?
29. Are all trust receipts required to be supported by invoices or other evidence that title to the security is vested in the bank?
30. Are trust receipts required to include:
  - a. Description of each item?
  - b. Serial number of each item?
  - c. Loan amount for each item?
  - d. Interest rate?
  - e. Date?
  - f. Authorized signature of dealer or person holding power-of-attorney to execute the trust receipt?
31. If the bank and dealer permit a bank employee to execute trust receipts using the dealer's power-of-attorney:
  - a. Are proper documents on file granting the power-of-attorney?
  - b. Does the bank maintain a numbered register for trust receipt notes?
  - c. Are trust receipt notes under dual control?

## OTHER

32. Are all floor plan loans granted under an established line?
33. Are line approvals structured to permit the bank to cancel or suspend shipments of unwanted merchandise?
34. Are dealer floor plan line limits strictly adhered to?
35. Is a trial balance of each dealer's trust receipts/security agreements prepared at least monthly?
36. Are dealer trial balances reconciled to department and general ledger controls?
37. Are floor plan interest charges systematically computed and regularly billed?
38. Are notices of past due interest payments sent promptly?
39. Are all interest, curtailment and unit pay off payments from dealers posted promptly?
40. Are disbursements for floor plan loans on new units made only against the original copy of the manufacturer's invoices?
41. Are the original invoices retained in the bank's files?
42. Are loan proceeds on new units paid directly to the manufacturer rather than to the dealer?
43. Are accounting records established so that the bank has records of all floored items with adequate individual identification?
44. Are limits on loan advance versus invoice price (current wholesale value, if used) clearly established?
45. Are wholesale values determined independently of dealer appraisals?

46. Are wholesale values that are assigned by floor plan department personnel periodically reviewed by someone independent of the department?
  47. Is amount of loan advance prohibited from exceeding 100 percent of the invoice price of a new item or of the wholesale value of a used item?
  48. Has a curtailment policy been established and is it being followed?
  49. Does the policy provide proper incentives to the dealer to turn over inventory on a timely basis?
  50. Is the loan written so that the floored items never depreciate faster than the loan balance is reduced?
  51. If a manufacturer of floored items has entered into a repurchase agreement, are curtailments structured to keep the loan balance in line with any declining repurchase amount?
  52. Are records maintained on curtailment billings so that delinquency is easily determinable?
  53. Are notices of past due curtailment payments sent promptly?
  54. If assignment of rebates has been made, have procedures been established to ensure that factory rebate checks payable at the end of the model year are promptly forwarded to the bank?
  55. If demonstrators are floored, are they subject to separate curtailment requirements which keep the loan balance in line with their liquidation value?
  56. Are floor plan agreements required for all dealers?
  57. Must agreements be accompanied by borrowing resolutions?
  58. Is a written agreement between the manufacturer and the bank required on any flooring line which includes drafting arrangements with the manufacturer?
  59. Do such agreements with the manufacturer stipulate under what conditions the bank will accept items to be floored?
  60. Are checks made periodically to determine that only those individuals granted power-of-attorney are signing the trust receipts?
  61. Are dealers required to submit financial and operating statements on a continuing basis?
  62. Are all dealers who prepare internal financial and operating statements more frequently than annually required to submit copies of those statements to the bank?
  63. Are all financial statements received from dealers reviewed promptly?
  64. Do financial statement reviews include a determination that floor plan loans, deposit accounts and other information agree with the bank's records?
  65. Are periodic reviews made of deposit accounts to detect any possible out-of-trust sales?
  66. Are periodic reviews made of the retail paper being generated to determine if the bank is receiving an adequate portion?
- ## CONCLUSION
67. Does the foregoing information constitute an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
  68. Based on a composite evaluation as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Leveraged financing is an important financing vehicle for mergers and acquisitions, business recapitalizations, and business expansions. Leveraged transactions are characterized by a degree of financial leverage that significantly exceeds industry norms, as measured by ratios such as debt-to-assets, debt-to-equity, cash flow-to-total debt, or other ratios and standards unique to particular industry norms for leverage. Leveraged borrowers typically have a diminished ability to respond to changing economic conditions or unexpected events, creating significant implications for an institution's overall credit-risk exposure and challenges for bank risk-management systems.

Leveraged-finance activities can be conducted in a safe and sound manner if a risk-management structure provides appropriate underwriting, pricing, monitoring, and controls. Comprehensive credit-analysis processes, frequent monitoring, and detailed portfolio reports are needed to better understand and manage the inherent risk in these leveraged-finance portfolios.

Many leveraged transactions are underwritten with reliance on the imputed value of a business (enterprise value), which is often highly volatile. Sound valuation methodologies must be used for these types of transactions, in addition to ongoing stress testing and monitoring of enterprise values.

On April 9, 2001, the Federal Reserve, along with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, issued the following guidance concerning sound risk-management practices for institutions engaged in leveraged financing.<sup>1</sup> The statement also provides guidance about risk-rating for leveraged-finance loans and how enterprise value should be evaluated in the risk-rating process. (See SR-01-9.) (The introductory paragraphs and some other material have been omitted from the policy statement here, as indicated by a line of asterisks. Other wording has been slightly altered, as indicated by brackets.)

1. This guidance augments previously issued supervisory statements on sound credit-risk management. See SR-99-23, "Recent Trends in Bank Lending Standards for Commercial Loans," and SR-98-18, "Lending Standards for Commercial Loans." (See also sections 2040.1, "Loan Portfolio Management," and 2040.3, "Examination Procedures—Loan Portfolio Management.")

## INTERAGENCY STATEMENT ON LEVERAGED FINANCING

\* \* \* \* \*

Institutions participate in leveraged financing on a number of levels. In addition to providing senior secured financing, they extend credit on a subordinated basis (mezzanine financing). Institutions and their affiliates also may take equity positions in leveraged companies with direct investments through affiliated securities firms, small business investment companies (SBICs), and venture capital companies or take equity interests via warrants and other equity "kickers" received as part of a financing package. Institutions also may invest in leveraged loan funds managed by investment banking companies or other third parties. Although leveraged financing is far more prevalent in large institutions, this type of lending can be found in institutions of all sizes \* \* \* The extent to which institutions should apply these sound practices will depend on the size and risk profile of their leveraged exposures relative to assets, earnings, and capital; and the nature of their leveraged-financing activities (i.e., origination and distribution, participant, equity investor, etc.) \* \* \*

### Risk-Management Guidelines

[Institutions substantively engaged in leveraged financing are expected to] adequately risk-rate, track, and monitor these transactions and to maintain policies specifying conditions that would require a change in risk rating, accrual status, loss recognition, or reserves. In general, the risk-management framework for leveraged finance is no different from that which should be applied to all lending activities. However, because of the potential higher level of risk, the degree of oversight should be more intensive.

### Loan Policy

The loan policy should specifically address the institutions' leveraged-lending activities by including—

- a definition of leveraged lending;

- an approval policy that requires sufficient senior-level oversight;
- pricing policies that ensure a prudent tradeoff between risk and return; and
- a requirement for action plans whenever cash flow, asset-sale proceeds, or collateral values decline significantly from projections. Action plans should include remedial initiatives and triggers for rating downgrades, changes to accrual status, and loss recognition.

### *Underwriting Standards*

Either the loan policy or separate underwriting guidelines should prescribe specific underwriting criteria for leveraged financing. The standards should avoid compromising sound banking practices in an effort to broaden market share or realize substantial fees. The policy should—

- describe appropriate leveraged loan structures;
- require reasonable amortization of term loans (i.e., allow a moderate time period to realize the benefit of synergies or augment revenues and institute meaningful repayment);
- specify collateral policies including acceptable types of collateral, loan-to-value limits, collateral margins, and proper valuation methodologies;
- establish covenant requirements, particularly minimum interest and fixed-charge coverage and maximum leverage ratios;
- describe how enterprise values and other intangible business values may be used; and
- establish minimum documentation requirements for appraisals and valuations, including enterprise values and other intangibles.

### *Limits*

Leveraged-finance and other loan portfolios with above-average default probabilities tend to behave similarly during an economic or sectoral downturn. Consequently, institutions should take steps to avoid undue concentrations by setting limits consistent with their appetite for risk and their financial capacity. Institutions should ensure that they monitor and control as separate risk concentrations those loan segments most vulnerable to default. Institutions may wish to identify such concentrations by the leveraged character-

istics of the borrower, by the institution's internal-risk grade, by particular industry or other factors that the institution determines are correlated with an above-average default probability. In addition, sublimits may be appropriate by collateral type, loan purpose, industry, secondary sources of repayment, and sponsor relationships. Institutions should also establish limits for the aggregate number of policy exceptions.

### *Credit Analysis*

Effective management of leveraged-financing risk is highly dependent on the quality of analysis during the approval process and after the loan is advanced. At a minimum, analysis of leveraged-financing transactions should ensure that—

- cash-flow analyses do not rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies;
- projections provide an adequate margin for unanticipated merger-related integration costs;
- projections are stress-tested for one or two downside scenarios;
- transactions are reviewed quarterly to determine variance from financial plans, the risk implications thereof, and the accuracy of risk ratings and accrual status;
- collateral valuations are derived with a proper degree of independence and consider potential value erosion;
- collateral-liquidation and asset-sale estimates are conservative;
- potential collateral shortfalls are identified and factored into risk-rating and accrual decisions;
- contingency plans anticipate changing conditions in debt or equity markets when exposures rely on refinancing or recapitalization; and
- the borrower is adequately protected from interest-rate and foreign-exchange risk.

### *Enterprise Value*

Enterprise value is often relied upon in the underwriting of leveraged loans to evaluate the feasibility of a loan request, determine the debt-reduction potential of planned asset sales, assess a borrower's ability to access the capital

markets, and to provide a secondary source of repayment. Consideration of enterprise value is appropriate in the credit-underwriting process. However, enterprise value and other intangible values can be difficult to determine, are frequently based on projections, and may be subject to considerable change. Consequently, reliance upon them as a secondary source of repayment can be problematic.

Because enterprise value is commonly derived from the cash flows of a business, it is closely correlated with the primary source of repayment. This interdependent relationship between primary and secondary repayment sources increases the risk in leveraged financing, especially when credit weaknesses develop. Events or changes in business conditions that negatively affect a company's cash flow will also negatively affect the value of the business, simultaneously eroding both the lender's primary and secondary source of repayment. Consequently, lenders that place undue reliance upon enterprise value as a secondary source of repayment or that utilize unrealistic assumptions to determine enterprise value are likely to approve unsound loans at origination or experience outsize losses upon default.

It is essential that institutions establish sound valuation methodologies for enterprise value, apply appropriate margins to protect against potential changes in value, and conduct ongoing stress testing and monitoring.

### *Rating Leveraged-Finance Loans*

Institutions need thoroughly articulated policies that specify requirements and criteria for risk-rating transactions, identifying loan impairment, and recognizing losses. Such specificity is critical for maintaining the integrity of an institution's risk-management system. Institutions' internal rating systems should incorporate both the probability of default and loss given default in their ratings to ensure that the risk of the borrower and the risk of the transaction structure itself are clearly evaluated. This is particularly germane to leverage-finance-transactions structures, which in many recent cases have resulted in large losses upon default.

In cases where a borrower's condition or future prospects have significantly weakened, leveraged-finance loans will likely merit a substandard classification based on the existence of well-defined weaknesses. If such weaknesses

appear to be of a lasting nature and it is probable that a lender will be unable to collect all principal and interest owed, the loan should be placed on nonaccrual and will likely have a doubtful component. Such loans should be reviewed for impairment in accordance with FAS 114, "Accounting by Creditors for Impairment of a Loan."

If the primary source of repayment is inadequate and a loan is considered collateral-dependent, it is generally inappropriate to consider enterprise value unless the value is well supported. Well-supported enterprise values may be evidenced by a binding purchase and sale agreement with a qualified third party or through valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, where a portion of the loan is not protected by pledged assets or a well-supported enterprise value, examiners will generally classify the unprotected portion of the loan doubtful or loss.

In addition, institutions need to ensure that the risks in leveraged-lending activities are fully incorporated in the allowance-for-loan-and-lease-loss and capital-adequacy analysis. For allowance purposes, leverage exposures should be taken into account either through analysis of the expected losses from the discrete portfolio or as part of an overall analysis of the portfolio utilizing the institution's internal risk grades or other factors. At the transaction level, exposures heavily reliant on enterprise value as a secondary source of repayment should be scrutinized to determine the need for and adequacy of specific allocations.

### *Problem-Loan Management*

For adversely rated borrowers and other high-risk borrowers who significantly depart from planned cash flows, asset sales, collateral values, or other important targets, institutions should formulate individual action plans with critical objectives and time frames. Actions may include working with the borrower for an orderly resolution while preserving the institution's interests, sale in the secondary market, and liquidation. Regardless of the action, examiners and bankers need to ensure such credits are reviewed regularly for risk-rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

### *Portfolio Analysis*

Higher-risk credits, including leveraged-finance transactions, require frequent monitoring by banking organizations. At least quarterly, management and the board of directors should receive comprehensive reports about the characteristics and trends in such exposures. These reports at a minimum should include—

- total exposure and segment exposures, including subordinated debt and equity holdings, compared to established limits;
- risk-rating distribution and migration data;
- portfolio performance—noncompliance with covenants, restructured loans, delinquencies, nonperforming assets, and impaired loans; and
- compliance with internal procedures and the aggregate level of exceptions to policy and underwriting standards.

Institutions with significant exposure levels to higher-risk credits should consider additional reports covering—

- collateral composition of the portfolio, e.g., percentages supported by working assets, fixed assets, intangibles, blanket liens, and stock of borrower's operating subsidiaries;
- unsecured or partially secured exposures, including potential collateral shortfalls caused by defaults that trigger *pari passu* [equable] collateral treatment for all lender classes;
- absolute amount and percentage of the portfolio dependent on refinancing, recapitalization, asset sales, and enterprise value;
- absolute amounts and percentages of scheduled and actual annual portfolio amortizations; and
- secondary-market pricing data and trading volume for loans in the portfolio.

### *Internal Controls*

Institutions engaged in leveraged finance need to ensure their internal-review function is appropriately staffed to provide timely, independent assessments of leveraged credits. Reviews should evaluate risk-rating integrity, valuation methodologies, and the quality of risk management. Because of the volatile nature of these credits, portfolio reviews should be conducted on at least an annual basis. For many institutions, the

risk characteristics of the leveraged portfolio, such as high reliance on enterprise value, concentrations, adverse risk-rating trends or portfolio performance, will dictate more frequent reviews.

### Distributions

Asset sales, participations, syndication, and other means of distribution are critical elements in the rapid growth of leveraged financing. [Lead and purchasing institutions are expected] to adopt formal policies and procedures addressing the distribution and acquisition of leveraged-financing transactions. The policies should include—

- procedures for defining, managing, and accounting for distribution fails;
- identification of any sales made with recourse and procedures for fully reflecting the risk of any such sales;
- a process to ensure that purchasers are provided with timely, current financial information;
- a process to determine the portion of a transaction to be held in the portfolio and the portion to be held for sale;
- limits on the length of time transactions can be held in the held-for-sale account and policies for handling items that exceed those limits;
- prompt recognition of losses in market value for loans classified as held-for-sale; and
- procedural safeguards to prevent conflicts of interest for both bank and affiliated securities firms.

### Participations Purchased

Institutions purchasing participations and assignments in leveraged finance must make a thorough, independent evaluation of the transaction and the risks involved before committing any funds. They should apply the same standards of prudence, credit assessment and approval criteria, and “in-house” limits that would be employed if the purchasing organization were originating the loan. At a minimum, policies should include requirements for—

- obtaining and independently analyzing full credit information both before the participa-

tion is purchased and on a timely basis thereafter;

- obtaining from the lead lender copies of all executed and proposed loan documents, legal opinions, title insurance policies, UCC searches, and other relevant documents;
- carefully monitoring the borrower's performance throughout the life of the loan; and
- establishing appropriate risk-management guidelines as described in this [statement.]

## Process To Identify Potential Conflicts

Examiners should determine whether an institution's board of directors and management have established policies for leveraged finance that minimize the risks posed by potential legal issues and conflicts of interest.

### *Conflicts of Interest*

When a banking company plays multiple roles in leveraged finance, the interests of different customers or the divisions of the institution may conflict. For example, a lender may be reluctant to employ an aggressive collection strategy with a problem borrower because of the potential impact on the value of the organization's equity interest. A lender may also be pressured to provide financial or other privileged client information that could benefit an affiliated equity investor. Institutions should develop appropriate policies to address potential conflicts of interest. Institutions should also track aggregate totals for borrowers and sponsors to which it has both a lending and equity relationship. Appropriate limits should be established for such relationships.

### *Securities Laws*

Equity interests and certain debt instruments used in leveraged lending may constitute "securities" for the purposes of federal securities laws. When securities are involved, institutions should ensure compliance with applicable securities law requirements, including disclosure and regulatory requirements.<sup>2</sup> Institutions

2. Institutions should also ensure that their acquired equity positions are consistent with equity ownership restrictions imposed by federal and state laws, such as the Bank Holding

should also establish procedures to restrict the internal dissemination of material nonpublic information about leveraged-finance transactions.

### *Compliance Function*

The legal and regulatory issues raised by leveraged transactions are numerous and complex. To ensure that potential conflicts are avoided and laws and regulations are adhered to, an independent compliance function should review all leveraged-financing activity.

\* \* \* \* \*

## EXAMINATION RISK-RATING GUIDANCE FOR LEVERAGED FINANCING

When evaluating individual borrowers, examiners should pay particular attention to—

- the overall performance and profitability of a borrower and its industry over time, including periods of economic or financial adversity;
- the history and stability of a borrower's market share, earnings, and cash flow, particularly over the most recent business cycle and last economic downturn; and
- the relationship between a borrowing company's projected cash flow and debt-service requirements and the resulting margin of debt-service coverage.

### *Cash Flow/Debt-Service Coverage*

Particular attention should be paid to the adequacy of the borrower's cash flow and the reasonableness of projections. Before entering into a leveraged-financing transaction, bankers should conduct an independent, realistic assessment of the borrower's ability to achieve the projected cash flow under varying economic and interest-rate scenarios. This assessment should take into account the potential effects of an economic downturn or other adverse business

Company Act and the Federal Reserve Act. Institutions need to take special care to aggregate all the equity positions held throughout the entire organization, including those held in all banking and nonbanking subsidiaries. [footnote added]

conditions on the borrower's cash flow and collateral values. Normally bankers and examiners should adversely rate a credit if material questions exist as to the borrower's ability to achieve the projected necessary cash flows, or if orderly repayment of the debt is in doubt. Credits with only minimal cash flow for debt service are usually subject to an adverse rating.

## Enterprise Value

Many leveraged-financing transactions rely on "enterprise value" as a secondary source of repayment. Most commonly, enterprise value is based on a "going concern" assumption and derived from some multiple of the expected income or cash flow of the firm. The methodology and assumptions underlying the valuation should be clearly disclosed, well supported, and understood by appropriate decision makers and risk-oversight units. Examiners should ensure that the valuation approach is appropriate for the company's industry and condition.

Enterprise value is often viewed as a secondary source of repayment and as such would be relied upon under stressful conditions. In such cases the assumptions used for key variables such as cash flow, earnings, and sale multiples should reflect those adverse conditions. These variables can have a high degree of uncertainty—sales and cash-flow projections may not be achieved; comparable sales may not be available; changes can occur in a firm's competitive position, industry outlook, or the economic environment. Because of these uncertainties, changes in the value of a firm's assets need to be tested under a range of stress scenarios, includ-

ing business conditions more adverse than the base-case scenario. Stress testing of enterprise values and their underlying assumptions should be conducted upon origination of the loan and periodically thereafter incorporating the actual performance of the borrower and any adjustments to projections. The bank should in all cases perform its own discounted-cash-flow analysis to validate "enterprise value" implied by proxy measures such as multiples of cash flow, earnings or sales.

Finally, it must be recognized that valuations derived with even the most rigorous valuation procedures are imprecise and may not be realized when needed by an institution. Therefore, institutions relying on enterprise value or illiquid and hard-to-value collateral must have lending policies that provide for appropriate loan-to-value ratios, discount rates and collateral margins.

## Deal Sponsors

Deal sponsors can be an important source of financial support for a borrower that fails to achieve cash-flow projections. However, support from this source should only be considered positively in a risk-rating decision when the sponsor has a history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. Even with capacity and a history of support, a sponsor's potential contributions should not mitigate criticism unless there is clear reason to believe it is in the best interests of the sponsor to continue that support or unless there is a formal guarantee.



# Leveraged Financing

## Examination Objectives

Effective date November 2001

## Section 2115.2

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1. To obtain assurances that the institution maintains sound lending standards.
2. To ensure that the institution's risk-management structure provides for appropriate underwriting, pricing, monitoring, and controls over leveraged-financing transactions.
3. To assess whether the institution uses comprehensive credit-analysis processes, whether frequent and continuous monitoring exists, and whether detailed portfolio reports are prepared and used to better understand and manage the inherent risk in leveraged-finance portfolios.
4. To ensure the institution uses sound valuation methodologies, conducts ongoing stress testing, and monitors enterprise values for leveraged-financing transactions.
5. To determine whether the institution's leveraged-financed loans are risk-rated and how enterprise values are evaluated in the risk-rating process.

# Leveraged Financing Examination Procedures

Effective date November 2001

## Section 2115.3

1. Ascertain that the institution has established procedures for determining which credits should be regarded as constituting “leveraged financing.”
2. Determine that the institution regularly reviews its leveraged-financing credits for their risk-rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.
3. Ascertain whether an institution’s board of directors and management have established policies for leveraged financing that minimize the risks of potential legal issues and conflicts of interest.
4. When reviewing leveraged-financing credits, give particular attention to—
  - the overall performance and profitability of a borrower and its industry over time, including periods of economic or financial adversity;
  - the history and stability of a borrower’s market share, earnings, and cash flow, particularly over the most recent business cycle and last economic downturn; and
  - the relationship between a borrowing company’s projected cash flow and debt-service requirements, the resulting margin of debt-service coverage, and actual performance.
5. Determine if the institution’s leveraged-finance rating systems incorporate both the probability of default and a realistic assessment of likely loss amounts in a troubled situation.
6. When a borrower’s condition or future prospects have significantly weakened, consider whether the leveraged-finance loans will likely merit an adverse rating based on the existence of well-defined weaknesses. If such weaknesses appear to be of a lasting nature and it is probable that a lender will be unable to collect all principal and interest owed, the loan should be placed on nonaccrual.<sup>1</sup>
7. Determine whether the valuation approach used for the leverage financing is appropriate for the company’s industry and condition.
8. When reviewing leveraged loans that are collateral-dependent, determine whether the loans are well protected by pledged assets or whether enterprise values are well supported.

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1. These loans should also be reviewed for impairment in accordance with Financial Accounting Standard No. 114 (FAS 114), “Accounting by Creditors for Impairment of a Loan.”

### INTRODUCTION

Leasing is a recognized form of financing for fixed assets that provides a lessee (the customer) the right to use depreciable assets without tying up working capital. Leasing frequently offers the lessee greater flexibility than traditional bank term-loan financing. Leasing also provides the lessor (the owner of the asset) with a generally higher rate of return than lending, but this is in exchange for assuming greater risk or investing more resources in marketing and deal structuring. The higher risk inherent in a typical lease transaction is due to the higher advance to collateral value; a longer payment period; and, in some cases, the lessor's dependence on the sale of the leased property to recover a portion of the initial investment. In most instances, some or all of the higher rate of return for the lessor is derived from the tax benefits of equipment ownership.

While leases differ from loans in some respects, they are similar from a credit viewpoint because the basic considerations are cash flow, repayment capacity, credit history, management, and projections of future operations. Additional considerations are the type of property being leased and its marketability in the event of default or termination of the lease. However, these latter considerations do not radically alter how an examiner evaluates collateral for a lease. The assumption is that the lessee/borrower will generate sufficient funds to liquidate the lease/debt. Leases are generally structured so that the bank recovers the full cost of the equipment plus an interest factor over the course of the lease term. Sale of the leased property/collateral remains a secondary source of repayment and, except for the estimated residual value at the expiration of the lease, will not, in most cases, become a factor in liquidating the advance.

In general, leasing activities of state member banks are governed by federal tax law and, in some instances, applicable state law. The leasing of personal or real property or acting as agent, broker, or adviser in leasing such property is considered a "closely related nonbanking activity" and is therefore permitted under section 225.28(b)(3) of Regulation Y by a bank holding company (BHC) or subsidiary thereof, in accordance with certain requirements. While not specifically applicable to banks, these crite-

ria provide useful guidelines for reviewing the appropriateness and prudence of bank leasing activities. Any substantial departure from these criteria must be judged in light of safety-and-soundness implications.

A BHC can act as an agent, broker, or adviser in leasing such property only if—

- the lease is on a nonoperating basis<sup>1</sup> and
- the initial term of the lease is at least 90 days.

For leases involving real property—

- the effect of the transaction at the inception of the initial lease must be to yield a return that will compensate the lessor for not less than the lessor's full investment in the property plus the estimated total cost of financing the property over the term of the lease, such return to be derived from rental payments, estimated tax benefits, and the estimated residual value of the property at the expiration of the initial lease; and
- the estimated residual value cannot exceed 25 percent of the acquisition cost of the property to the lessor.

Examiners should ensure that the bank's policies and procedures appropriately govern its direct-lease-financing activities and that bank management adheres to established policies and procedures. Examiners should also ensure that the bank's audit and loan-review functions adequately encompass the leasing activity.

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1. With respect to the "nonoperating basis" requirement, a BHC may not, directly or indirectly, engage in operating, servicing, maintaining, or repairing leased property during the term of the lease. For automobile leasing, this requirement means that a BHC may not, directly or indirectly, (1) provide servicing, repair, or maintenance of the leased vehicle during the lease term; (2) purchase parts and accessories in bulk or for an individual vehicle after the lessee has taken delivery of the vehicle; (3) provide the loan of an automobile during servicing of the leased vehicle; (4) purchase insurance for the lessee; or (5) provide for the renewal of the vehicle's license merely as a service to the lessee when the lessee could renew the license without authorization from the lessor. The BHC can arrange for a third party to provide these services or products.

## ACCOUNTING FOR LEASES

Since leasing activity became prominent within the last few decades, lessors have employed a number of different methods to account for their investments in leases. Financial Accounting Standards Board (FASB) Statement No. 13, "Accounting for Leases," effective January 1, 1977, was intended to bring uniformity to lease accounting.<sup>2</sup> Pursuant to the guidance, a lease is generally structured as a direct financing lease and reported as such on the institution's accounting records. A direct financing lease is a type of capital lease<sup>3</sup> that transfers substantially all the benefits and risks inherent in the ownership of the leased property to the lessee. In addition, collection of the minimum lease payments must be reasonably predictable, and no important uncertainties may exist regarding costs to be incurred by the lessor under the terms of the lease. Although minor variations in accounting methods are still found, most investment-in-leases accounts will be equal to—

- the sum of the minimum lease payments to be received from the lessee, plus
- the unguaranteed residual value (estimated fair market value) of the property at the end of the lease term, reduced by
- the amount of unearned and deferred income to be recognized over the life of the lease.

For the purpose of illustration, assume that property costing \$120,000 is leased for a period of 96 months at \$1,605 per month, and the estimated residual value (ERV) of the property is \$24,000. In this example, income is recognized monthly according to the sum of the months' digits method. The investment in this lease is calculated below, followed by an explanation of each component of the net investment.

Cost	\$120,000
Unearned income	34,080
Rentals receivable (96 × \$1,605)	154,080
Est. residual value	24,000
Gross investment	178,080
Less:	
Unearned income	34,080
Unearned income (ERV)	24,000
Net investment	120,000

### Rentals Receivable

This account is established in the amount of total rental payments to be received from the lessee. The amount by which the rentals receivable (\$154,080) exceeds the cost of the property (\$120,000) is the functional equivalent of interest and represents a portion of the income to be recognized over the life of the lease. In the example below, the cost of the property is temporarily charged to a fixed-asset account, then transferred to rentals receivable.

2. Other Financial Accounting Standards Board releases dealing with leasing are FASB Statements 22, 23, 27, 28, 29, 76, 77, 91, 94, 98, and 109; FASB Interpretations 19, 21, 23, 24, 26, and 27; and FASB Technical Bulletins 79-10, 79-12, 79-13, 79-14, 79-15, 79-16, 85-3, 86-2, and 88-1.

3. FASB Statement No. 13, paragraph 7, outlines in detail certain criteria that a lease must meet for it to be classified as a capital lease. (See also the call report instructions.)

Fixed assets	\$120,000	
Cash		120,000
To record purchase or property for lease		
Rentals receivable	154,080	
Fixed assets		120,000
Unearned income		34,080
To record amount due from lessee		

Throughout the lease term, the rentals-receivable account is periodically reduced by the full amount of each rental payment received.

Cash	\$1,605	
Rentals receivable		1,605
To record receipt of monthly payment		

## Estimated Residual Value

The estimated residual value represents the proceeds the lessor expects to realize at the end of the lease term from the sale or re-leasing of the property. Exactly as its title states, this account represents only an estimate of future value and does not represent current market value or depreciated book value. The residual value at the end of the lease term is considered to be income, and the corresponding credit for this asset account is posted to unearned income.

The balance of the ERV account does not normally change significantly during the lease term. The unguaranteed residual value should be reviewed at least annually to determine whether a decline, other than a temporary one, has occurred in its estimated value. If a decline is not temporary, the accounting for the lease transaction should be revised using the new estimate, and the resulting loss should be recognized in the period that the change is made. Upward adjustments or increases in the residual value are not recognized.

After the end of the term, the residual value account is eliminated from the books upon sale, re-lease, or other disposition of the property. If the amount of proceeds received differs from the

recorded residual value, the difference will be recognized as either a gain or loss, whichever is appropriate.

Est. residual value	\$24,000	
Unearned income		24,000
To record ERV of leased property		
Cash	26,000	
Est. residual value		24,000
Gain on sale		2,000
To record sale of property		

Any portion of the ERV guaranteed by a party unrelated to the lessor would be deducted from the ERV account and added to rentals receivable.

## Unearned Income

This liability account has a credit balance and is netted against the total of rentals receivable and the ERV for balance-sheet presentation. Its component parts are the "interest" income equal to the excess of rentals receivable over the cost of the property and the income to be realized from disposition of the property at the end of the lease term. Each of these components is recognized as income throughout the life of the lease by periodic transfers to earned income. Unearned income is amortized to income over the lease term to produce a constant periodic rate of return on the net investment in the lease. Any other method, such as the sum-of-the-months'-digits method, may be used if the results obtained are not materially different from those that would result from the interest method described in the preceding sentence and if the resulting impact does not overstate income during the current period. Loan-origination fees and initial direct costs, such as commissions and fees that are incurred by the lessor in negotiating and consummating the lease, are offset against each other, and the resulting net amount is deferred and recognized over the lease term. The practice of recognizing a portion of the unearned income at the inception of the lease to offset initial direct costs is no longer acceptable.

## Depreciation

For certain leases, the lessor is entitled to claim depreciation for tax purposes. However, for financial statement purposes, no depreciation for leased property will appear on the income statement and no accumulated depreciation will appear on the balance sheet. If the lessor is entitled to the benefits of depreciation, then, for tax purposes only, depreciation will be calculated and will reduce the lessor's tax liability.

The lessor's entitlement to depreciation tax benefits is a function of the type of lease arrangement negotiated. When the lessor retains title to the asset and owns the asset at the expiration of the lease, the lessor may take depreciation into account for tax purposes. These characteristics are typical of a "true," "net," or "capital" lease, terms often used interchangeably in the industry. In a "financing" lease, the lessee rather than the lessor acquires title to the property at the expiration of the lease and is entitled to depreciation tax benefits. Accordingly, the lessor will charge the lessee a higher periodic lease payment (for a higher "rate of return") to offset its loss of depreciation tax benefits.

## Balance-Sheet Presentation

Lease receivables are to be reported on the balance sheet as the single amount "net investment" (see below). If the lessor has established an allowance for possible lease losses, this amount is included in the total allowance for loan and lease losses and represents a deduction from the net investment. Footnotes to the balance sheet should disclose the components of the net investment, as follows:

Rentals receivable	\$154,080
Est. residual value	<u>24,000</u>
Gross investment	178,080
Less:	
Unearned income	<u>58,080</u>
Net investment	<u>\$120,000</u>

For call report purposes, lease financing receivables are reported net of unearned income as part of an institution's total loans.

## Classification

If it is deemed appropriate to classify a lease, the amount at which the lease would be classified is the net investment. For example, assume that 94 of the 96 payments have been received on the above lease, that income has been recognized monthly according to the sum-of-the-months'-digits method, and that the lease is now considered a loss. Its balance on the books is \$27,173, as follows:

Rentals receivable	\$ 3,210
Est. residual value	<u>24,000</u>
Gross investment	27,210
Less:	
Unearned income	22
Unearned income (ERV)	<u>15</u>
Net investment	<u>27,173</u>

Classification of the \$27,173 balance of this lease involves classifying \$3,188 of the unrecovered portion of the cost of the property (\$3,210 less \$22 unearned income) plus \$23,985 of income that has already been recognized in anticipation of receiving the ERV (\$24,000 less \$15 not yet recognized). In short, the calculation is  $\$3,188 + \$23,985 = \$27,173$ .

Charging off the ERV included in the net investment treats the lease as if the underlying property has no value and, in effect, reverses the unearned income that has been recognized in anticipation of selling the leased property at its recorded ERV. Accordingly, if the property does have value, the \$27,173 classified should be reduced by the net amount that the lessor could realize by selling the property.

## Delinquency

It is appropriate for the examination report to state the percentage of delinquency in the lease portfolio. The percentage is calculated by dividing the aggregate rentals receivable on delinquent leases (less the "interest" components of their unearned income accounts) by the total of rentals receivable on all leases (less the "interest" components of their unearned income accounts). ERVs would not be included in the

delinquent amounts since they do not represent obligations of the lessees.

If the lease obligation in the previously described classification example was the only delinquent obligation in a portfolio of leases with component accounts as shown below, the rate of delinquency in the portfolio would be 3.4 percent.

Rentals receivable	\$ 94,411
Est. residual value	<u>705,882</u>
Gross investment	800,293
Less:	
Unearned income	647
Unearned income (ERV)	<u>441</u>
Net investment	\$799,205
<hr/>	
\$3,210 – 22	
<u>                  </u> = 3.4%	
\$94,411 – 647	

## Termination of a Lease

The termination of a lease is recognized in the income of the period in which the termination occurs by eliminating the remaining net investment from the lessor's account. The lease property is then recorded as an asset using the lower of the original cost, present fair value, or present carrying amount.

## LEVERAGED LEASES

Leveraged leasing is a specialized form of financing and should only be pursued by banks with the appropriate expertise. Part of the examiner's duty is to determine that the personnel who structure and follow leveraged leases are highly qualified in that area and have a current working knowledge of applicable tax laws and regulations.

A leveraged lease transaction is complex in terms of size, the number of parties involved, legal involvement, and, of course, the unique advantages to all parties. Legal expenses and administrative costs associated with leveraged leasing limit its use to financing large capital-equipment projects. By tailoring the tax effects to the needs of the parties involved, the structure

of a leveraged lease permits multiple tax benefits and maximum investment return. The lessor is in search of a tax shelter to offset income generated from other sources, while the lessee bargains for lower rental charges in exchange for the tax advantage the lessor receives. The result of this trade-off ideally produces an attractive rate of return on the lessor's invested dollars, while the lessee conserves working capital and obtains financing at a cost substantially below the lessee's usual borrowing rate.

In a leveraged lease, the lessor purchases and becomes owner of the equipment by providing only a percentage (usually 20 to 40 percent) of the capital needed. The rest of the purchase price is borrowed by the lessor from long-term lenders on a nonrecourse basis. The borrowings are secured by a first lien on the equipment, an assignment of the lease, and an assignment of the lease payments.

If the purchase price of the equipment is large, there may be several equity owners and debtholders involved. In this case, an owner trustee may be named to hold title to the equipment and to represent the equity owners. An indenture trustee may be named to hold the mortgage on the property for the benefit of the debtholders.

The lessor (equity holder), as the owner, is allowed to take accelerated depreciation based on the total cost of the equipment. The lessor might also receive a small portion of the rental payments, but the desired yield is obtained from the timing of depreciation. The effect gives the lessor a return through the small rentals and allows the lessor to retain the residual value rights to the equipment at the end of the lease period.

The bank should consider its present and anticipated future tax position, its future money rates, and the residual value of the property. The return on the bank's investment in leveraged leases depends largely on these factors. A slight change can precipitate significant changes in the bank's position. Anticipated proceeds from the sale or re-leasing of the property at the conclusion of the lease term (the residual value) is an important element of the return and should be estimated carefully. It will, in most cases, exceed 25 percent of the purchase price because of certain tax requirements. The bank should continually evaluate the property for misuse, obsolescence, or market decline, all of which can rapidly deteriorate the value of the property before the lease term expires. In these cases, the

lessee may default, often with expensive consequences for the lessors.

The examiner should remember that a portion of the bank's recapture of its investment in leased property is often predicated on the inherent tax benefits. Accordingly, a decline in the bank's ability to use these tax benefits could reduce or eliminate the profitability of the venture.

The complexity of leveraged leasing should motivate the examiner to carefully scrutinize each indenture and all parties concerned before any analysis begins. The examiner should approach each lease from the standpoint of the creditworthiness of the lessee and the continuous assessment of the value of the leased property. If the lessee defaults, the loan participant is

in a position to foreclose and leave the bank without a way to recapture the carrying value of its investment. Therefore, the general rule is that a bank should not enter into a leveraged lease transaction with any party to which it would not normally extend unsecured credit.

The lessor's net investment in a leveraged lease shall be recorded in a manner similar to that for a direct financing lease, but net of the principal and interest on the nonrecourse debt. The components of the net investment, including related deferred taxes, should be fully disclosed in the footnotes to the lessor's financial statements when leveraged leasing is a significant part of a bank's business activities. (See appendix E of FASB 13 for an example of how to account for a leveraged lease.)



# Direct Financing Leases

## Examination Objectives

Effective date May 1996

## Section 2120.2

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1. To determine if lease policies, practices, procedures, objectives, and internal controls are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the adequacy of collateral, credit quality, and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

# Direct Financing Leases

## Examination Procedures

Effective date March 1984

## Section 2120.3

1. If selected for implementation, complete or update the Direct Financing Leases section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control" and determine if corrections have been accomplished.
4. The following information should be available at the start of the examination:
  - a. trial balance of all leases and outstanding credits
  - b. listing of accounts on which payments are delinquent 30 days or more or on which payments are otherwise not being made according to schedule
  - c. listing of available lines of credit
  - d. minutes of board and executive meetings since the date of the previous examination
5. Using an appropriate sampling technique, select leases for review.
6. Obtain liability and other information on common borrowers from examiners assigned cash items, overdrafts, and other loan areas and together decide who will review the borrowing relationship.
7. For leases selected for review, analyze the creditworthiness of the lessees. Consideration is given to the figures derived from the lessee's financial statements, as well as to cash flow, trends and projections of growth in sales and income, and the qualifications of management. Delinquency on a lease obligation is potentially more serious than delinquency on a conventional loan because, if the property under lease is necessary for the lessee's continued production of income, as is frequently the case, the lessee's financial condition will be seriously deteriorated before the lessee is willing to risk losing the property by default.
8. For those leases which might result in loss to the lessor or for which financial information was not adequate to make such a determination, transcribe the following information to line cards:
  - a. name and line of business of lessee
  - b. name of guarantor(s)
  - c. original date of the lease contract
  - d. original amount of the rentals receivable
  - e. ERV of the property
  - f. amount of ITC to be realized
  - g. book value of the investment in the lease as of the examination date
  - h. cost of the property
  - i. description and location of the property
  - j. amount and frequency of rental payments
  - k. original amount, term, rate, and schedule of amortization of any nonrecourse debt associated with the lease
  - l. lessor's percentage of equity participation in the lease obligation, if applicable
  - m. summary financial data indicating the creditworthiness of the lessee and guarantors, if applicable
9. Before the conclusion of the examination, discuss with management all classified leases. Inadequate or negative cash flow and unfavorable trends reflected in financial statements of the lessee are usually indicative of a substandard lease. Leases classified doubtful typically include those on which payments are delinquent for an extended period and those on which the lessor's recovery of investment is dependent upon an event of unknown probability, such as a pending lawsuit or insurance claim. A loss classification results from the lessee's inability or refusal to continue making payments.
10. Prepare write-ups to support the classifications. The write-up should include the lessee's type of business, present financial status, circumstances that led to the classification, the probability that the terms of the lease can be met, and the amount of protection afforded by sale or release of the underlying property.
11. Review a sample of the lessor's computations of lease yields to determine whether the lessor will recover the cost of purchasing and the after-tax cost of financing the

property during the initial term of the lease or 40 years, whichever is less.

Shown below are the amounts which may be applied against the purchase and financing costs in calculating recovery.

- a. Total of lease payments and ERV, reduced by the estimated taxes to be paid on unearned income. The amount of the ERV used in this calculation may not exceed 20 percent of acquisition cost, though it is permissible for the ERV to be carried on the books in an amount exceeding 20 percent of cost.
- b. ITC to be realized by the lessor.
- c. Tax benefits resulting from depreciation charges, equal to total allowable depreciation times the lessor's marginal tax rate. Depreciation for tax purposes is calculated on the basis of total original cost ignoring ERV. However, over time, accumulated depreciation may not exceed original cost less ERV.
- d. For personal property leases of seven years or less, any additional amount provided by an unconditional guarantee of the lessor's full recovery of investment plus financing cost. The guarantee can be made by a lessee, an independent third party, or manufacturer deemed creditworthy by the lessor. In determining full-payout compliance, the guarantee may only account for up to 60 percent of the acquisition cost of the property.

The following example of a payout calculation assumes a marginal tax rate of 46 percent and depreciation of the full cost of the property for tax purposes:

Total lease payments	\$154,080	
ERV	24,000	
ITC (tax benefit)	12,000	
Depreciation—tax benefit (46% × 120,000)	<u>55,200</u>	
Subtotal		<u>\$245,280</u>
Less taxes on unearned income:		
("interest")	\$34,080	
(ERV)	<u>24,000</u>	
46% × \$58,080	<u>26,717</u>	
		<u>\$218,563</u>

After deducting the \$120,000 cost of the property from the net cash flow provided by the lease, after-tax funds of \$98,563 are available to cover the cost of financing the property. Dividing this amount by the assumed marginal tax rate of 46 percent indicates that the equivalent amount in pre-tax funds is \$214,267. If this \$214,267 were paid as interest over a 96-month period to finance the acquisition of property costing \$120,000, the annual rate of interest (internal rate of return) would be 32.0 percent (see compound interest chart). No further calculation need be made since this high percentage based on funds available to cover finance costs would exceed by far the lessor's likely approximate pre-tax cost of funds. However, in those instances in which the percentage calculated is believed to closely approximate the cost of funds, the lessor should be asked to explain the manner by which its recovery of cost is assured.

If this example were a personal property lease with a term of seven years or less, any qualified guarantee up to 60 percent of acquisition cost could have been considered as an addition to the funds available to provide the lessor with full payout.

As mentioned in the introduction to this section, an exception to the full-payout requirement is made for leases to those governmental entities that are prohibited from entering into leases for periods exceeding one year. In the case of leases to government entities, the lessor should demonstrate that the lease is expected to be continually renewed until the cost is fully recovered.

12. Review records to determine that the lease transaction constitutes a valid lease for tax purposes. If the agreement is ruled by the IRS to be a "conditional sale," the lessor would not be entitled to depreciation charges or the ITC, and the lessee would be required to deduct depreciation charges rather than lease payments from taxable income. It is preferable that the lessor obtain a private ruling from the IRS to make certain that it qualifies as the original user of the property and is therefore entitled to the previously mentioned tax benefits. Circumstances that the IRS considers as evidence of a conditional sale rather than a lease are as follows:
  - a. portions of the rental payments are made

- applicable to an equity interest of the lessee in the property
- b. the lessee acquires title to the property after making a specified number of payments
  - c. the payments made by the lessee for a short period of use constitute an unusually large percentage of the purchase price of the property
  - d. the total rental payments to be received exceed the current fair rental value of the property, indicating that the payments include an element other than rent
  - e. the lessee has an option to purchase the property at a price that is nominal in relation to the value of the property or to the total amount of rental payments
  - f. a portion of each rental payment is readily identifiable as the equivalent of interest
13. Ascertain whether title to the property rests with the lessor and that the lessor has taken steps to protect its ownership rights. Evidence of filing under the Uniform Commercial Code, where appropriate, should be found in the documentation file. Aircraft should be registered with the FAA, interstate vehicles with the ICC, and ships with the Coast Guard.
  14. Check for cancellation or other provisions in the contract that could jeopardize the full-payout status of the lease. There is no need to take exception to a cancellation provision that provides for payment by the lessee of an amount that allows the lessor to fully recover its investment in the property.
  15. Check that insurance coverage on leased property is provided by the lessee in compliance with all insurance provisions of the contract in an amount sufficient to protect against loss from property damage. Public liability insurance should also be provided to protect against loss from lawsuits that could arise from situations such as the crash of leased aircraft.
  16. Review the lessee's duties under the contract with respect to repairs and taxes. Determine whether the lessor has instituted procedures to check that the lessee's required duties are being performed.
  17. Review the status of all property acquired for lease purposes but which is not now under lease. Determine the reason for the "off-lease" status of the property, ascertain the realizable value of the property, and investigate whether the off-lease property will be sold or re-leased within the required two-year period.
  18. Investigate the lessor's procedures for periodic review of the reasonableness of the estimated residual value. The estimate should be reviewed at least annually and reduced in amount on the books if the value has declined on a presumably permanent basis.
  19. Review past operations of the lessee company to determine if projections of income and ERV have been realistic in light of actual experience.
  20. Review the minutes of the meetings of the board and executive committees to determine whether purchases of property and delinquent leases are reported to the board.
  21. Determine if the bank has entered into leases with companies owned or controlled by any director or officer. Compare the rates and terms on such leases to the rates and terms offered on leases to companies of similar credit standing.
  22. Check for lease concentrations to any one lessee or industry and prepare a comment for the examination report if any concentration is considered unwarranted.
  23. Determine whether the bank has established limits for the maximum amount of "credit" to be extended to a single lessee. If these limits have been established, investigate whether the bank adheres to them. If they have not been established, inquire as to the bank's policy on this matter.
  24. Check for action taken on matters criticized in the most recent audit reports and the previous examination report. Determine if leases classified "loss" were removed from the books.
  25. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of—
    - a. delinquent leases, including those considered "A" paper;
    - b. violations of laws and regulations;
    - c. leases not supported by current and complete financial information;
    - d. leases on which documentation is deficient;
    - e. equipment deficiencies revealed in inspection reports;
    - f. off-lease equipment;
    - g. concentrations of leases;
    - h. classified leases; and

- i. leases to major shareholders, employees, officers, directors, and/or their interests.
- 26. Update workpapers with any information that will facilitate future examinations.

# Direct Financing Leases Internal Control Questionnaire

Effective date March 1984

## Section 2120.4

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

### POLICIES AND OBJECTIVES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written direct lease financing policies that—
  - a. establish procedures for reviewing direct lease financing applications,
  - b. define qualified property, and
  - c. establish minimum standards for documentation?
2. Are direct lease financing policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

- \*3. Is the preparation and posting of subsidiary direct lease financing records performed or reviewed by persons who do not also—
  - a. issue official checks and drafts or
  - b. handle cash?
- \*4. Are the subsidiary direct lease financing records reconciled, at least monthly, with the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?
5. Are delinquent account collection requests and past-due notices checked to the trial balances that are used in reconciling subsidiary records of direct lease receivables to general ledger accounts, and are they handled only by persons who do not also handle cash?
6. Are inquiries about lease balances received and investigated by persons who do not also handle cash or pass adjustments?
- \*7. Are documents supporting recorded credit

adjustments checked or tested subsequently by persons who do not also handle cash or initiate transactions (if so, explain briefly)?

### INTEREST AND/OR RENT

- \*8. Is the preparation and posting of interest and/or rent records performed or reviewed by persons who do not also—
  - a. issue official checks and drafts or
  - b. handle cash?

### DEPRECIATION (OPERATING LEASES)

9. Is the preparation and posting of periodic depreciation records performed or reviewed by persons who do not also have sole custody of property?
10. Do the bank's procedures require that depreciation expense be charged at least quarterly?
- \*11. Are the subsidiary depreciation records balanced, at least quarterly, to the appropriate general ledger controls by persons who do not also have sole custody of property?

### OTHER

- \*12. Are periodic property inventory reports prepared by the lessee or trustee?
13. Do reports clearly indicate the condition and location of the leased property?
14. When inspection of the equipment leased is either infrequent or not feasible, has the bank taken measures to protect its equipment and prevent its misuse?
15. At lease termination, are outside appraisals made of property before bids are accepted?
16. Are review procedures in effect to maintain the necessary insurance coverage on all leased assets regardless of whether the cost of this insurance is to be borne by the bank or the lessee?
17. Does the bank have insurance coverage against its potential public liability risk as owner/lessor of the property?

18. Are safeguards in effect to prevent the possibility of conflict of interest or self-dealing in selecting the seller, servicer, insurer, or purchaser for the equipment leased?
19. Are separate files maintained for each lease transaction?
20. Does each file supporting the acquisition and disposal of assets reflect the review and written approval of an officer other than the person who actually controlled the disbursement and receipt of funds?
21. Are all leases required to be supported by current credit information?
22. Do modifications of terms require the approval of the board or committee that initially approved the lease?
23. If commitments are issued contingent upon receipt of certain satisfactory information, has authority to reject or accept such information been vested in someone other than the account officer?
24. Is residual value substantiated by periodic appraisals?
25. Are reports listing past-due leases and/or those receiving special attention submitted to the board for review at their regular meetings?

## CONCLUSION

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

This section applies to most types of loans found in a consumer loan department. Consumer credit, also referred to as retail credit, is defined as credit extended to individuals for household, family, and other personal expenditures, rather than credit extended for use in a business or for home purchases. Consumer credit loans are loans not ordinarily maintained by either the commercial or real estate loan departments. Consumer loans frequently make up the largest number of loans originated and serviced by the bank, but their dollar volume may be significantly less than for other types of loans. Consumer credit loans may be secured or unsecured and are usually structured with short- or medium-term maturities. Broadly defined, consumer credit includes all forms of *closed-end credit (installment credit)* and *open-end credit (revolving credit)*, such as check credit and credit card plans. Consumer credit also includes loans secured by an individual's personal residence, such as home equity and home-improvement loans. Home equity loans are discussed in "Real Estate Loans," section 2090.1.

The examiner should determine the adequacy of the consumer credit department's overall policies, procedures, and credit quality. The examiner's goal should not be limited to identifying current portfolio problems but should also include identifying potential problems that may result from liberal lending policies, unfavorable trends, potentially imprudent concentrations, or nonadherence to established policies. Banks lacking written policies, or failing to implement or follow established policies effectively, should be criticized in the report of examination.

## TYPES OF CONSUMER CREDIT

### Installment Loans

Many traditional forms of installment credit have standard monthly payments and fixed repayment schedules of one to five years. These loans are made with either fixed or variable interest rates that are based on specific indices. Installment loans fill a variety of needs, such as financing the purchase of an automobile or household appliance, financing home improvement, or consolidating debt. These loans may be unsecured or secured by an assignment of title,

as in an automobile loan, or by money in a bank account.

A bank's installment loan portfolio usually consists of a large number of small loans, each scheduled to be amortized over a specific period. Most installment loans are made for consumer purchases; however, amortizing commercial loans are sometimes placed in the installment loan portfolio to facilitate their servicing. In addition, the installment loan portfolio can consist of both loans made by the bank and loans purchased from retail merchants who originated the loans to finance the sale of goods to their customers.

### *Indirect Installment Loans*

Indirect installment loans are also known as dealer loans, sales-finance contracts, or dealer paper. In this type of consumer credit, the bank purchases, sometimes at a discount, loans originated by retailers of consumer goods, such as a car dealer. This type of lending is called indirect lending because the dealer's customer indirectly becomes a customer of the bank.

The sales-finance contracts purchased from dealers of consumer goods are generally closed-end installment loans with a fixed rate of interest. These loans are purchased in one of three ways depending on the dealer and the circumstances of purchase:

- *Without recourse.* The bank is responsible for collecting the account, curing the delinquency, or applying the deficiency against dealer reserves or holdback accounts. The majority of sales-finance contracts with dealers are without recourse.
- *Limited recourse.* The dealer will repurchase the loan, cure the default, or replace the loan only under certain circumstances in accordance with the terms of the agreement between the bank and the dealer.
- *With recourse.* The dealer is required to repurchase the loan from the bank on demand, typically within 90 to 120 days of default.

In the case of recourse and limited-recourse loans, legal lending limitations need to be considered.

Sales-finance contracts purchased without recourse from dealers should be based on the



individual's creditworthiness, *not* on the financial strength of the dealership itself. The contracts purchased should comply with the bank's loan policy for similar consumer loans. Exceptions to the bank's policies and procedures should be documented in the credit file and have the appropriate level of approval. For sales-finance contracts purchased with recourse that do not meet the bank's normal credit criteria and are purchased on the basis of the added strength of the dealer, the bank should document the minimum criteria for such loans and the specific bank-approved financial covenants with which the dealer must comply.

## Check Credit and Overdraft Protection

Check credit is defined, for the purpose of this manual, as the granting of unsecured, interest-bearing revolving lines of credit to individuals or businesses. Such extensions of credit are subject to the disclosure requirements of the Truth in Lending Act (TILA). Banks provide check-credit services through overdraft protection, cash reserves, and special drafts.

The most common product is overdraft line-of-credit protection, whereby a transfer is made from a preestablished line of credit to a customer's deposit account when a check is presented that would cause the account to be overdrawn. Transfers normally are made in specific increments, up to a maximum line of credit approved by the bank.

In a cash reserve system, the customer must request that the bank transfer funds from a preestablished line of credit to his or her deposit account. To avoid overdrawing the account, the customer must request the transfer before negotiating a check against the account.

In a special draft system, the customer negotiates a special check drawn directly against a preestablished line of credit. In this method, deposit accounts are not affected.

In all three systems, the bank periodically provides its check-credit customers with a statement of account activity. Required minimum payments are computed as a fraction of the balance in the account on the cycle date and may be made by automatic charges to the deposit account.

Banks also provide credit through ad hoc and automated overdraft-protection programs. Typi-

cally, ad hoc programs involve insured depository institutions' providing discretionary coverage of customers' overdrafts on a case-by-case basis. Automated overdraft-protection programs, also referred to as *bounced-check protection* or *overdraft protection*, are credit programs increasingly offered by institutions to transaction-account (typically deposit-account) customers as an alternative to traditional check-credit and ad hoc programs for covering overdrafts.

Under both the ad hoc and automated programs, regardless of whether an overdraft is paid, institutions typically impose a fee when an overdraft occurs. This fee is referred to as a nonsufficient-funds, or NSF, fee. Unlike the discretionary ad hoc accommodation typically provided to those lacking a line of credit or other type of overdraft service (such as linked accounts), automated programs are often marketed to consumers and may give consumers the impression that the service is a guaranteed short-term credit facility. These marketed programs typically provide consumers with an express overdraft "limit" that applies to their account.

Neither the ad hoc nor the automated overdraft programs are subject to the annual percentage rate (APR) disclosure requirements of TILA. These programs are, however, subject to the disclosure requirements of the Truth in Savings Act (TISA) and Regulation DD.

The specific details of institutions' overdraft-protection programs have varied over time. The programs currently offered by institutions incorporate some or all of the following characteristics:

- Institutions inform consumers that overdraft protection is a feature of their accounts and promote consumers' use of the service. Institutions may also inform consumers of their aggregate dollar limit under the overdraft-protection program.
- Coverage is automatic for consumers who meet the institution's criteria (for example, the account has been open a certain number of days, and deposits are made regularly). Typically, the institution performs no credit underwriting.
- Overdrafts generally are paid up to the aggregate limit set by the institution for the specific class of accounts. Limits are typically \$100 to \$500.
- Many program disclosures state that payment of an overdraft is discretionary on the part of the institution and may disclaim any legal

obligation of the institution to pay any overdraft.

- The service may extend to check transactions as well as other transactions, such as withdrawals at automated teller machines (ATMs), transactions using debit cards, preauthorized automatic debits from a consumer's account, telephone-initiated funds transfers, and online banking transactions.
- A flat fee is charged each time the service is triggered and an overdraft item is paid. Commonly, a fee in the same amount would be charged even if the overdraft item was not paid for nonsufficient funds. A daily fee may also apply for each day the account remains overdrawn.
- Some institutions offer closed-end loans to consumers who do not bring their accounts to a positive balance within a specified time period. These repayment plans allow consumers to repay their overdrafts and fees in installments.

To assist insured depository institutions in the responsible disclosure and administration of overdraft-protection services, particularly those that are marketed to consumers (a depository institution's customers), the federal banking and thrift agencies issued Joint Guidance on Overdraft Protection Programs. The interagency guidance, issued on February 18, 2005, addresses the agencies' concerns about the potentially misleading implementation, marketing, disclosure, and operation of these programs. (See the "Best Practices" section of the guidance.) The guidance also discusses the agencies' safety-and-soundness considerations and the legal risks of such programs. Institutions are encouraged to carefully review their programs to ensure that their marketing and other communications concerning the programs (1) do not mislead consumers into believing that their programs are traditional lines of credit (when they are not) or that payment of overdrafts is guaranteed, (2) do not mislead consumers about their account balance or the costs and scope of the overdraft protection offered, and (3) do not encourage irresponsible consumer financial behavior that may potentially increase the institution's risk. See SR-05-3 and the attached interagency guidance for detailed discussions of the agencies' concerns and best practices (for marketing and communication with consumers and program features and operation). See also section 3000.1.

### *Safety-and-Soundness Considerations*

When overdrafts are paid, credit is extended to an institution's customers. To the extent overdraft-protection programs lack individual account underwriting, these programs may expose an institution to more credit risk (higher delinquencies and losses) than overdraft lines of credit and other traditional overdraft-protection options.

Institutions providing overdraft-protection programs should adopt written policies and procedures adequate to address the credit, operational, and other risks associated with these types of programs. Prudent risk-management practices include the establishment of express account-eligibility standards and well-defined and properly documented dollar-limit decision criteria. Institutions should also monitor these accounts on an ongoing basis and be able to identify consumers who may represent an undue credit risk to the institution. Overdraft-protection programs should be administered and adjusted, as needed, to ensure that credit risk remains in line with expectations. Program adjustments may include, as appropriate, disqualification of a consumer from future overdraft protection. Management should regularly receive reports sufficient to enable it to identify, measure, and manage overdraft volume, profitability, and credit performance.

Institutions are also expected to incorporate prudent risk-management practices related to account repayment and suspension of overdraft-protection services. These practices include the establishment of specific time frames for when consumers must pay off their overdraft balances. For example, procedures should be established for the suspension of overdraft services when an account holder no longer meets the eligibility criteria (such as when the account holder has declared bankruptcy or defaulted on another loan at the bank) as well as for when an account holder does not repay an overdraft. In addition, overdraft balances should generally be charged off when considered uncollectible, but no later than 60 days from the date first overdrawn. In some cases, an institution may allow a consumer to cover an overdraft through an extended repayment plan when the consumer is unable to bring the account to a positive balance within the required time frames. The existence of the repayment plan, however, would not extend the charge-off determination period beyond 60 days (or a shorter period if applicable), as measured from the date of the overdraft. Any payments

received after the account is charged off (up to the amount charged off against the allowance for loan and lease losses) should be reported as a recovery.

Some overdrafts are rewritten as loan obligations in accordance with an institution's loan policy and are supported by a documented assessment of that consumer's ability to repay. In those instances, the institution should use the charge-off time frames described in the Federal Financial Institutions Examination Council's Uniform Retail Credit Classification and Account Management Policy (revised June 6, 2000; effective December 31, 2000). (See SR-00-8.)

Institutions should follow generally accepted accounting principles and the instructions for the Reports of Condition and Income (Call Reports) to report income and loss recognition on overdraft-protection programs. Overdraft balances should be reported on the Report of Condition of the bank Call Report as loans. Accordingly, overdraft losses should be charged off against the allowance for loan and lease losses. All institutions are expected to adopt rigorous loss-estimation processes to ensure that overdraft-fee income is accurately measured. Such methods may include providing loss allowances for uncollectible fees or, alternatively, only recognizing that portion of earned fees estimated to be collectible.<sup>1</sup> The procedures for estimating an adequate allowance should be documented in accordance with the July 2, 2001, interagency Policy Statement on the Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions.<sup>2</sup> (See SR-01-17.)

If an institution advises account holders of the available amount of overdraft protection, for example, when accounts are opened or on depositors' account statements or automated teller machine (ATM) receipts, the institution should report the available amount of overdraft protection with its other legally binding commitments, for Call Report purposes. These available amounts, therefore, should be reported as "unused commitments."

### *Risk-Based Capital Treatment of Overdraft Balances*

Banks are expected to provide proper risk-based capital treatment of outstanding overdrawn balances and unused commitments. Overdraft balances should be risk-weighted according to the obligor. Under the risk-based capital guidelines, the capital charge on the unused portion of commitments is generally based on an off-balance-sheet credit-conversion factor and the risk weight appropriate to the obligor. (See section 3020.1.) In general, the capital guidelines provide that the unused portion of a commitment is subject to a zero percent credit-conversion factor if the commitment has an original maturity of one year or less, or to a 50 percent credit-conversion factor if the commitment has an original maturity over one year. Under the guidelines, a zero percent conversion factor also applies to the unused portion of a "retail credit card line" or "related plan" if it is unconditionally cancelable by the institution in accordance with applicable law. (See 12 CFR 208, appendix A, section III.D.5.) The phrase "related plans" in the guidelines includes overdraft checking plans. The overdraft-protection programs discussed in the agencies' February 18, 2005, guidance fall within the meaning of "related plans" as a type of "overdraft checking plan" for the purposes of the federal banking agencies' risk-based capital guidelines. Consequently, overdraft-protection programs that are unconditionally cancelable by the institution in accordance with applicable law would qualify for a zero percent credit-conversion factor.

Institutions entering into overdraft-protection contracts with third-party vendors must conduct thorough due-diligence reviews before signing a contract. The November 30, 2000, interagency guidance Risk Management of Outsourced Technology Services outlines the agencies' expectations for prudent practices in this area. (See section 4060.1 and SR-00-17.)

### *Legal Risks*

Overdraft-protection programs must comply with all applicable federal laws and regulations, including the Federal Trade Commission Act (as outlined below). State laws may also be applicable, including usury and criminal laws, as well as laws on unfair or deceptive acts or practices. Before implementing an overdraft-protection

1. Uncollected overdraft fees may be charged off against the allowance for loan and lease losses if such fees are recorded with overdraft balances as loans and if estimated credit losses on the fees are provided for in the allowance for loan and lease losses.

2. The interagency policy statement was issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

program, institutions should have their program reviewed by counsel for compliance with all applicable laws. Further, although the agencies' guidance outlines the applicable federal laws and regulations as of February 2005, such laws and regulations are subject to amendment. Accordingly, institutions should monitor applicable laws and regulations for revisions and ensure that their overdraft-protection programs are fully compliant.

*Federal Trade Commission Act.* Section 5 of the Federal Trade Commission Act (the FTC Act) prohibits unfair or deceptive acts or practices (15 USC 45). The banking agencies enforce this section pursuant to their authority in section 8 of the Federal Deposit Insurance Act (12 USC 1818).<sup>3</sup> An act or practice is unfair if it causes or is likely to cause substantial injury to consumers that is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition. An act or practice is deceptive if, in general, it is a representation, omission, or practice that is likely to mislead a consumer acting reasonably under the circumstances and if the representation, omission, or practice is material.

Overdraft-protection programs may raise issues under the FTC Act, depending on how the programs are marketed and implemented. Institutions should closely review all aspects of their overdraft-protection programs, especially any materials that inform consumers about the programs, to avoid engaging in deceptive, inaccurate, misrepresentative, or unfair practices.

### *Examiner's Review of Delinquencies Involving Check-Credit (Overdraft-Protection) Plans*

Delinquencies are often experienced when an account is at or near the customer's maximum credit line. Examiners should verify that the following reports are generated for and reviewed by bank management, and examiners should also analyze them as part of the examination process:

- aging of delinquent accounts
- accounts on which payments are made (either

3. See the March 2002 OCC Advisory Letter 2002-3 and the March 11, 2004, joint Federal Reserve Board and FDIC interagency guidance *Unfair or Deceptive Acts or Practices by State-Chartered Banks*.

on this account or other loans) by drawing on reserves

- accounts with steady usage

Many banks offer check-credit plans to small businesses; these plans may have a higher-than-normal degree of risk unless they are offered under very stringent controls. In these situations, the examiner's review should be based on the same factors and criteria used for the review of unsecured commercial loans.

## Credit Card Plans

Most bank credit card plans are similar. The bank solicits retail merchants, service organizations, and others who agree to accept a credit card in lieu of cash for sales or services performed. The bank assumes the credit risk and charges the nonrecourse sales draft to the individual customer's credit card account. The bank sends monthly statements to the customer, who may elect to pay the entire amount or to pay in monthly installments, with an additional percentage charge on the outstanding balance each month. A cardholder may also obtain cash advances, which accrue interest from the transaction date, from the bank or automated teller machines.

A bank can be involved in a credit card plan in various ways. Also, the terminology used to describe the manner in which a bank is involved in a credit card plan may vary. The examiner first needs to determine the type of credit card plan that the bank has and then ascertain the degree of risk that the plan poses to the bank.

Both the bank's customers and the bank itself can generate potential risk in the credit card department. On the customer side, the risk is generally divided into two categories: the misuse of credit and the misuse of the credit card. The potential for credit misuse is reduced by careful screening of cardholders before cards are issued and by monitoring individual accounts for abuse. Credit card misuse may be reduced by establishing controls to prevent the following abuses:

- employees or others from intercepting the card before delivery to the cardholder
- merchants from obtaining control of cards
- fraudulent use of lost or stolen cards

Because credit cards may be easily misused by the cardholders and others who may obtain the cards, strict adherence to appropriate internal controls and operating procedures is essential in any credit card department. The examiner should determine if adequate controls and procedures exist.

*Account Management, Risk Management, and the Allowance for Loan and Lease Losses*

Credit card lending programs can generate risk through inappropriate account-management, risk-management, and loss-allowance practices. Banks should have and follow prudent policies for credit-line management, over-limit practices, minimum payments, negative amortization, workout and forbearance practices, and recovery practices. In addition, banks should follow generally accepted accounting principles (GAAP), existing interagency policies, and Call Report instructions for income-recognition and loss-allowance practices. In arriving at an overall assessment of the adequacy of a bank's account-management practices for its credit card lending business, examiners should incorporate the risk profile of the bank, the quality of management reporting, and the adequacy of the bank's charge-off policies and its allowance for loan and lease losses methodologies and documentation practices. (See SR-03-01 and the FFIEC January 8, 2003, interagency guidance on credit card lending.)

*Credit-line management.* Banks should carefully consider the repayment capacity of borrowers when assigning initial credit lines or significantly increasing borrowers' existing credit lines. When a bank inadequately analyzes the repayment capacity of a borrower, practices such as liberal line-increase programs and multiple card strategies can increase the risk profile of a borrower quickly and result in rapid and significant portfolio deterioration.

Credit-line assignments should be managed conservatively using proven credit criteria. Support for credit-line management should include documentation and analysis of decision factors such as a borrower's repayment history, risk scores, behavior scores, or other relevant criteria.

Banks can significantly increase their credit exposure by offering customers additional cards, including store-specific private-label cards and

affinity-relationship cards, without considering their entire relationship with a customer. In extreme cases, some banks may grant additional cards to borrowers who are already experiencing payment problems on their existing cards. Banks that offer multiple credit lines should have sufficient internal controls and management information systems (MIS) to aggregate related exposures and analyze performance before they offer additional credit lines to customers.

*Over-limit practices.* Account-management practices that do not adequately control authorization and provide for timely repayment of over-limit amounts may significantly increase the credit-risk profile of a bank's portfolio. While prudent over-limit practices are important for all credit card accounts, such practices are especially important for subprime accounts. Liberal over-limit tolerances and inadequate repayment requirements in subprime accounts can magnify the high risk exposure of the lending bank, and deficient reporting and loss-allowance methodologies can understate the credit risk.

All banks should carefully manage their over-limit practices and focus on reasonable control and timely repayment of amounts that exceed established credit limits. A bank's MIS should be sufficient to enable its management to identify, measure, manage, and control the unique risks associated with over-limit accounts. Over-limit authorization on open-end accounts, particularly those that are subprime, should be restricted and subject to appropriate policies and controls. The bank's objective should be to ensure that the borrower remains within prudent established credit limits that increase the likelihood of responsible credit management.

*Minimum payment and negative amortization.* Competitive pressures and a desire to preserve outstanding balances can lead to a bank's easing of minimum-payment requirements, which in turn can increase credit risk and mask portfolio quality. These problems are exacerbated when minimum payments consistently fall short of covering all finance charges and fees assessed during the billing cycle and when the outstanding balance continues to build (known as "negative amortization"). In these cases, the lending bank is recording uncollected income by capitalizing the unpaid finance charges and fees into the account balance the customer owes. The pitfalls of negative amortization are magnified when subprime accounts are involved—and are



even more damaging when the condition is prolonged by programmatic, recurring over-limit fees and other charges that are primarily intended to increase recorded income for the lending bank rather than enhance the borrowers' performance or their access to credit.

The Federal Reserve expects lending banks to require minimum payments that will amortize the current balance over a reasonable period of time, consistent with the unsecured, consumer-oriented nature of the underlying debt and the borrower's documented creditworthiness. Examiners should criticize prolonged practices involving negative amortization and inappropriate fees, as well as other practices that inordinately compound or protract consumer debt and disguise portfolio performance and quality, all of which raise safety-and-soundness concerns.

*Workout and forbearance practices.* Banks should properly manage workout programs.<sup>3a</sup> Areas of concern involve liberal repayment terms with extended amortizations, high charge-off rates, moving accounts from one workout program to another, multiple re-agings, and poor MIS to monitor program performance. Examiners should criticize management and require appropriate corrective action when workout programs are not managed properly. Such actions may include adversely classifying entire segments of portfolios, placing loans on nonaccrual, increasing loss allowances to adequate levels, and accelerating charge-offs to appropriate time frames.

Workout programs should be designed to maximize principal reduction and should generally strive to have borrowers repay credit card debt within 60 months. Repayment terms for workout programs should be consistent with these time frames; exceptions should be clearly documented and supported by compelling evi-

dence that less conservative terms and conditions are warranted. To meet the appropriate time frames, banks may need to substantially reduce or eliminate interest rates and fees on credit card debt so that more of the payment is applied to reducing the principal.

In lieu of workout programs, banks sometimes negotiate settlement agreements with borrowers who are unable to service their unsecured open-end credit. In a settlement arrangement, the bank forgives a portion of the amount owed. In exchange, the borrower agrees to pay the remaining balance either in a lump-sum payment or by amortizing the balance over several months.

*Income-recognition and ALLL methodologies and practices.* Most banks use historical net charge-off rates, which are based on a migration analysis of the roll rates<sup>3b</sup> to charge-off, as the starting point for determining appropriate loss allowances. Banks then typically adjust the historical charge-offs to reflect current trends and conditions and other factors.

Banks should evaluate the collectibility of accrued interest and fees on credit card accounts because a portion of accrued interest and fees is generally not collectible.<sup>3c</sup> Although regulatory reporting instructions do not require consumer credit card loans to be placed on nonaccrual on the basis of their delinquency status, all banks should employ appropriate methods to ensure that income is accurately measured. Such methods may include providing loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status. Banks must account for the owned portion of accrued interest and fees, including related estimated losses, separately from the retained interest in accrued interest and fees from credit card receivables that have been securitized.

A bank's allowance for loan and lease losses should be adequate to absorb credit losses that are probable and estimable on all loans. While some banks provide for an ALLL on all loans, others may only provide for an

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3a. A workout is a former open-end credit card account in which credit availability has been closed and the balance owed has been placed on a fixed (dollar or percentage) repayment schedule in accordance with modified, concessionary terms and conditions. Generally, the repayment terms require amortization or liquidation of the balance owed over a defined payment period. Such arrangements are typically used when a customer is either unwilling or unable to repay the open-end credit card account in accordance with the original terms but shows the willingness and ability to repay the loan in accordance with modified terms and conditions.

Workout programs generally do not include temporary-hardship programs that help borrowers overcome temporary financial difficulties. However, temporary-hardship programs longer than 12 months, including renewals, should be considered workout programs.

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3b. *Roll rate* is the percentage of balances or accounts that move from one delinquency stage to the next delinquency stage.

3c. AICPA Statement of Position 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*, provides guidance on accounting for delinquency fees.

ALLL on loans that are delinquent. This last practice may result in an inadequate ALLL. Banks should ensure that their loan-impairment analysis and ALLL methodology, including the analysis of roll rates, consider the losses inherent in both delinquent and nondelinquent loans.

A bank's allowance methodologies should always fully recognize the losses inherent in over-limit portfolio segments. For example, if a bank requires borrowers to pay monthly over-limit and other fees in addition to the minimum monthly payment amount, roll rates and estimated losses may be higher than indicated in the overall portfolio migration analysis. Accordingly, banks should ensure that their allowance methodology addresses the incremental losses that may be inherent in over-limit accounts.

A bank's allowances should appropriately provide for the inherent probable loss in workout programs, particularly when a program has liberal repayment periods with little progress in reducing principal. Accounts in workout programs should be segregated for performance-measurement, impairment-analysis, and monitoring purposes. When multiple workout programs with different performance characteristics exist, a bank should track each program separately and establish and maintain adequate allowances for each program. Generally, the allowance allocation should equal the estimated loss in each program based on historical experience as adjusted for current conditions and trends. These adjustments should take into account changes in economic conditions, the volume and mix of loans in each program, the terms and conditions of each program, and loan collection activities.

Banks should ensure that they establish and maintain adequate loss allowances for credit card accounts that are subject to settlement arrangements. In addition, the FFIEC Uniform Retail Credit Classification and Account Management Policy states that "actual credit losses on individual retail loans should be recorded when the bank becomes aware of the loss." In general, the amount of debt forgiven in a settlement arrangement should be classified as loss and charged off immediately. Immediate charge-off, in some circumstances, however, may be impractical. In such cases, banks may treat amounts forgiven in settlement arrangements as specific allowances.<sup>4</sup> Upon receipt of the final

settlement payment, banks should charge off deficiency balances within 30 days.

*Recovery practices.* After a credit card loan is charged off, banks must properly report any subsequent collections on the loan.<sup>5</sup> Typically, banks report some or all of such collections on charged-off credit card loans as recoveries to the ALLL. If the total amount a bank credits to the ALLL as the recovery on an individual credit card loan (which may include principal, interest, and fees) exceeds the amount previously charged off against the ALLL on that loan (which may have been limited to principal), then the bank's net charge-off experience—an important indicator of the credit quality and performance of its portfolio—will be understated. Banks must ensure that the total amount credited to the ALLL as recoveries on a loan (which may include amounts representing principal, interest, and fees) is limited to the amount previously charged off against the ALLL on that loan. Any amounts collected in excess of this limit should be recognized as income.

*Re-aging of credit card receivables.* The examiner should review the bank's credit card receivables to determine if re-aging occurs. Re-aging refers to the removal of a delinquent account from normal collection activity after the borrower has demonstrated over time that he or she is capable of fulfilling contractual obligations without the intervention of the bank's collection department. The bank may use re-aging when a customer makes regular and consecutive payments over a period of time that maintain the account at a consistent delinquency level or reduce the delinquency level with minimal collection effort. Re-aging, in effect, changes the delinquency-payment status of a credit card receivable from a past-due to a current status. The examiner should determine if the bank re-ages its accounts on an exception basis or as a regular practice. The bank should document those accounts that have been re-aged, obtain appropriate approval, and ensure that re-aging is done in conformance with internal policies and procedures. (See "Bank Classification and Charge-Off Policy" later in this section and SR-00-8 for further guidance.)

4. For regulatory reporting purposes, banks should report the creation of a specific allowance as a charge-off in Schedule

RI-B of the call report.

5. AICPA Statement of Position 01-6 provides recognition guidance for recoveries of previously charged-off loans.

*Exceptions to examiner guidance.* From time to time, banks with well-managed programs may authorize, and provide a basis for granting, limited exceptions to the FFIEC Uniform Retail Credit Classification and Account Management Policy. The basis for granting exceptions to the policy should be identified and described in the bank's policies and procedures. Such policies and procedures should address the types of exceptions allowed and the circumstances for permitting them. The volume of accounts granted exceptions should be small and well controlled, and the performance of these accounts should be closely monitored. Examiners will evaluate whether a bank uses its exceptions prudently. Examiners should criticize management and require corrective action when exceptions are not used prudently, are not well managed, result in improper reporting, or mask delinquencies and losses.

## LOAN POLICY

A written consumer credit policy provides bank management with the framework to underwrite and administer the risk inherent in lending money while establishing a mechanism for the board of directors or senior management to monitor compliance. The policy should establish the authority, rules, and guidelines to operate and administer the bank's consumer loan portfolio effectively; that is, the policy should help manage risk while ensuring profitability. The policy should set basic standards and procedures clearly and concisely. The policy's guidelines should be derived from a careful review of internal and external factors that affect the bank. To avoid any discriminatory policies or practices, the policy should include guidelines on the various consumer credit laws and regulations.

The composition of the loan portfolio will differ considerably among banks because lending activities are influenced by many factors, including the type of institution, management's objectives and philosophies on diversification and risk, the availability of funds, and credit demand. An effective lending policy and commensurate procedures are integral components of the lending process. The bank's consumer credit policy should accomplish the following:

- define standards, rules, and guidelines for the

credit-evaluation process, with the following specific goals:

- establish minimum and maximum loan maturities
- establish minimum levels of creditworthiness
- create consistency within the bank's underwriting process
- ensure uniformity in how the bank's consumer credit products are offered to borrowers
- provide a degree of flexibility, which allows credit officers and management to use their knowledge, skills, and experience
- provide specific guidelines for determining the creditworthiness of applicants; these guidelines might include the following:
  - minimum income levels
  - maximum debt-to-income ratios
  - job or income stability
  - payment history on previous obligations
  - the type and value of collateral
  - maximum loan-to-value ratios on various types of collateral
  - a minimum score on a credit scoring system
- provide guidelines for the level and type of documentation to be maintained, including—
  - a signed application
  - the identity of the borrower and his or her occupation
  - documentation of the borrower's financial capacity
  - a credit bureau report
  - the purpose of all loans granted to the borrower, the sources of repayment, and the repayment programs
  - documentation of the collateral, its value, and the source of the valuation
  - documents perfecting the lien on the collateral
  - verification worksheets and supporting documentation
  - a credit scoring worksheet, if applicable
  - the sales contract and related security agreements, if applicable
  - evidence of insurance coverage, if applicable
  - any other documentation received or prepared in conjunction with the credit request
- define procedures for handling delinquent consumer credit loans and the subsequent charge-off and possible re-aging of those loans

The consumer credit policy should also provide



guidelines for granting loans that do not conform to the bank's written lending policy or procedures. The policy should require that the reason for the exception be detailed in writing, submitted for approval to a designated authority, and documented in the loan file. Credit exceptions should be reviewed by the appropriate bank committee. The frequency of exceptions granted may indicate a lessening of underwriting standards or a need to adjust the policy to allow flexibility within safe and sound parameters. The examiner should assess the exceptions and make recommendations accordingly.

Obtaining and maintaining complete and accurate information on every consumer credit applicant is essential to approving credit in a safe and sound manner. The loan policy should establish what information will be required from the borrower during the application process and what, if any, subsequent information the borrower will be required to submit while the credit remains outstanding. Credit files should be maintained on all borrowers, regardless of the credit amount, with the exception of the latitude provided by the March 30, 1993, Interagency Policy Statement on Documentation of Loans. Each borrower's credit file should include the names of all other borrowers who are part of the same borrowing relationship, or the bank should have some other system for informing the reader of a credit file that the borrower is part of a more extensive credit relationship. A current credit file should provide the loan officer, loan committee, and internal and external reviewers with all information necessary to (1) analyze the credit before it is granted and (2) monitor the credit during its life.

Documentation requirements will vary according to the type of loan, borrower, and collateral. For example, the bank may not require a financial statement from a borrower whose loans are fully secured by certificates of deposit issued by the bank. For most consumer credit loans, the borrower's financial information is collected only at the time of the loan application.

## OPERATIONAL RISK

The management of the consumer credit function and the accompanying internal controls is of primary importance to the safe, sound, and profitable operation of a bank. In evaluating controls for consumer credit administration, the examiner should review (1) the bank's adher-

ence to policies and procedures and (2) the operational controls over recordkeeping, payments, and collateral records to ensure that risks are controlled properly. (See "Loan Portfolio Management," section 2040.1, for an overview of the various types of risk that the bank should be aware of and the controls it should implement to effectively manage risk.) Risks that are inherent to the consumer credit function and that require internal controls include, but are not limited to, the following:

- *Insurance.* All insurance policies on file should name the bank as loss payee. The bank should maintain a tickler system to monitor the expiration of insurance policies. In addition, the bank should implement procedures to ensure single-interest insurance coverage is obtained in case the borrower's insurance is canceled or expires.
- *Security agreements.* The bank should implement procedures to ensure that lien searches are performed and that liens are perfected by appropriate filings.
- *Indirect installment loans.* The bank should implement procedures to reduce the risk that can occur in this area. These procedures should ensure the following:
  - payments are made directly to the bank and not through the dealer
  - dealer lines are reaffirmed at least annually
  - selling prices as listed by the dealer are accurate
  - credit checks on the borrowers are performed independently of the dealer
  - overdrafts are prohibited in the dealer reserve and holdback accounts
  - past-due accounts are monitored in aggregate per dealer to assess the quality of loans received from each individual dealer

## CREDIT SCORING SYSTEM

Credit scoring is a method for predicting how much repayment risk consumer credit borrowers present. Credit scoring systems are developed using application or credit bureau data on consumers whose performance has already been categorized as creditworthy or noncreditworthy. Items of information that help predict acceptable performance are identified and assigned point values relative to their overall importance. These values are then totaled to calculate an overall credit score.

The credit score is used to approve credit, and frequently allows a bank to avoid the costly and time-consuming process of individual underwriting. Management determines a minimum score, which is sometimes called the cutoff score. Borrowers whose credit scores are not within the approved cutoff-score range for the type of loan requested do not meet the bank's minimum underwriting criteria. However, the bank may override a borrower's unacceptable credit score when other mitigating factors are present that may not have been included in the credit score. Exceptions to the bank's credit scoring system should be documented.

A number of banks have developed and implemented credit scoring systems as part of the approval process for consumer credit; other banks use traditional methods that rely on a credit officer's subjective evaluation of an applicant's creditworthiness. Credit scoring systems are replacing credit officers' subjective evaluation of borrowers' creditworthiness in more and more banks, particularly in larger institutions. Credit scoring systems are divided into two categories: (1) empirically derived, demonstrably and statistically sound credit systems and (2) judgmental systems.

Empirically derived credit scoring systems are generally defined as systems that evaluate creditworthiness by assigning points to various attributes of the applicant and, perhaps, to attributes of the credit requested. The points assigned are derived from a statistical analysis of recent creditworthy and noncreditworthy applicants of the bank. An empirically derived credit scoring system is statistically sound when it meets the following requirements:

- The data used to develop the system are derived from an empirical comparison of sample groups or from the population of creditworthy and noncreditworthy applicants who applied for credit within a reasonably recent period of time.
- The system is developed to evaluate the creditworthiness of applicants in order to serve the legitimate business interests of the bank using the system.
- The system is developed and validated using statistical principles and methodology.
- The bank periodically reevaluates the predictive ability of the system by using statistical principles and methodologies and adjusts the system as necessary.

An empirically derived credit scoring system may take the age of an applicant into account as a predictive variable, provided that the age of an elderly applicant is not assigned a negative factor or value. In a judgmental system, which relies on a credit officer's personal evaluation of a potential borrower's creditworthiness, a creditor may not take age directly into account. However, the applicant's age may be related to other information that the creditor considers in evaluating creditworthiness. For example, a creditor may consider the applicant's occupation and length of time to retirement to ascertain whether the applicant's income (including retirement income) will support the extension of credit to maturity. Consumer credit regulations allow any system of evaluating creditworthiness to favor an applicant who is 62 or older.

If the bank has a credit scoring system, the examiner should review the items or customer attributes that are included in it. In general, credit scoring systems are built on an experiential or historical database. Credit scoring methods analyze the experiences of individuals who have been previously granted credit and divide them into creditworthy and noncreditworthy accounts for purposes of predicting future extensions of consumer credit.

A successful credit scoring system provides a standardized way of measuring the inherent risk of the borrower. An important measure of any credit scoring system is its definition of risk and the care with which explanatory variables are defined, data are collected, and the system is tested. The standardized risk measurement should be fundamentally sound, be based on historical data, measure the risk of default (or loss), and produce consistent results across time for a wide range of borrowers. The bank should further investigate potential borrowers who do not meet the credit scoring criteria.

Some banks may use more than one type of credit scoring methodology in their underwriting and account-management practices. The following are three examples of credit scoring systems:

- *Credit bureau scoring.* The bank uses a consumer's credit bureau information in a scoring formula. The scoring model is developed by the various credit bureaus, using the reported experience of all credit grantors with whom the applicant has or has had a relationship.
- *Custom-application scoring.* The bank uses both a consumer's application and credit

bureau data in a scoring formula. This scoring model is developed using only information on the bank's applicants and borrowers.

- *Behavioral scoring.* The bank uses a formula that includes a borrower's repayment history, account utilization, and length of time with the bank to calculate a risk score for revolving accounts.

Applicants who fail the scoring process may still be judgmentally reviewed if additional information exists that may not have been included in the scoring formula. In addition, if an applicant passes the scoring process, but other information indicates that the loan should not be made, the applicant can be denied but the reason for the credit denial should be documented.

## BANK CLASSIFICATION AND CHARGE-OFF POLICY

Consumer credit loans, based on their volume and size, are generally classified using criteria that are different from the classification of other types of loans. The examiner should use the Uniform Retail Credit Classification and Account Management Policy<sup>6</sup> when determining consumer credit classifications. (See the appendix to this section.)

A bank should have procedures detailing when consumer credit loans become watch list or problem credits. In addition, the bank should have charge-off procedures for consumer credit loans. The examiner should review the bank's policies and procedures for adequacy and compliance.

Identification of unfavorable trends must include the review of past-due percentages and income and loss trends in the consumer credit department, which management should monitor closely. Unfortunately, in banks that lack a well-enforced charge-off program, loss ratios

are often meaningless for periods of less than a year. As a result, bank management may not become aware of downward trends until year-end or examiner-initiated charge-offs are made. Recognition and implementation of any necessary corrective action are thus delayed.

The examiner should determine whether the bank has adopted a well-enforced charge-off procedure. If so, his or her review should be limited to ascertaining that exceptions meet established guidelines. If the bank is properly charging off delinquent consumer credit loans in the normal course of business under a policy that generally conforms to that of the Federal Reserve System, no specific request for charge-off should be necessary. When the bank has not established a program to ensure the timely charge-off of delinquent accounts, such a program should be recommended in the examination report. If material misstatements in the FFIEC Consolidated Reports of Condition and Income (Call Reports) for previous quarters have resulted from management's failure to charge off loans, management should be instructed to amend the Call Reports for each affected quarter. The following loans are subject to the uniform classification policy:

- All loans to individuals for household, family, and other personal expenditures as defined in the Call Reports.
- Mobile home paper, except when applicable state laws define the purchase of a mobile home as the purchase of real property and the loan is secured by the purchased mobile home as evidenced by a mortgage or similar document.
- Federal Housing Authority (FHA) title 1 loans. These loans are also subject to the following classification criteria:
  - Uninsured portions should be charged off when claims have been filed.
  - When claims have not been filed, uninsured delinquent portions should be classified in accordance with the delinquent-installment-loan classification policy.
  - The portion covered by valid insurance is not subject to classification.

The uniform classification policy includes consumer credit loans. Small, delinquent consumer credit loans may be listed for classification purposes in the report of examination without detailed comments. Larger classified consumer loans might need to be supported with detailed comments. When no specific proce-

6. The 1980 Federal Financial Institutions Examination Council (FFIEC) policy was revised and issued in February 1999 and June 2000. The June 2000 policy replaces the 1980 policy and its February 1999 revision. Reporting on the FFIEC Call Report, based on the revised policy, is not required until December 31, 2000. In addition to discussing the revised policy statement, SR-00-8 advises examiners to consider the methodology used for aging retail loans. In accordance with the FFIEC Call Report instructions, banks and their consumer finance subsidiaries are required to use the contractual method, which ages loans based on the status of contractual payments.

dures have been established, or when adherence to the established procedures is not evident, the examiner should make every effort to encourage the bank to adopt and follow acceptable procedures.

## REPOSSESSED PROPERTY

Repossessed property should be booked at its fair value, less cost to sell, on the date the bank obtains clear title and possession of the property. Any outstanding loan balance in excess of the fair value of the property, less selling costs, should be charged off. Periodic repricing should be performed, and appropriate accounting entries should be made when necessary. Generally, repossessed property should be disposed of within 90 days of obtaining possession, unless legal requirements stipulate a longer period.

## VIOLATIONS OF LAW

The consumer credit department is particularly susceptible to violations of the various consumer credit laws and regulations. These types of violations may result in serious financial penalties and loss of public esteem. Therefore, the examiner must be aware of any violations discovered during the consumer compliance examination and ensure that corrective action has been effected. All examiners should be familiar with the various consumer credit laws and regulations and be alert to potential violations.

## APPENDIX—RETAIL-CREDIT CLASSIFICATION POLICY

*The revised June 2000 Uniform Retail Credit Classification and Account Management Policy issued by the FFIEC and approved by the Federal Reserve Board is reproduced below. The Board has clarified certain provisions of this policy. In this text, the Board's revisions are in brackets.*

The Uniform Retail Credit Classification and Account Management Policy<sup>1</sup> establishes standards for the classification and treatment of retail credit by financial institutions. Retail credit consists of open- and closed-end credit extended

to individuals for household, family, and other personal expenditures, and includes consumer loans and credit cards. For purposes of this policy, retail credit also includes loans to individuals secured by their personal residence, including first mortgage, home equity, and home-improvement loans. Because a retail-credit portfolio generally consists of a large number of relatively small-balance loans, evaluating the quality of the retail-credit portfolio on a loan-by-loan basis is inefficient and burdensome for the institution being examined and for examiners.

Actual credit losses on individual retail credits should be recorded when the institution becomes aware of the loss, but in no case should the charge-off exceed the time frames stated in this policy. This policy does not preclude an institution from adopting a more conservative internal policy. Based on collection experience, when a portfolio's history reflects high losses and low recoveries, more conservative standards are appropriate and necessary.

The quality of retail credit is best indicated by the repayment performance of individual borrowers. Therefore, in general, retail credit should be classified based on the following criteria:

- Open- and closed-end retail loans past due 90 cumulative days from the contractual due date should be classified substandard.
- Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be classified loss and charged off.<sup>2</sup> In lieu of charging off the entire loan balance, loans with non-real estate collateral may be written down to the value of the collateral, less cost to sell, if repossession of collateral is assured and in process.
- One- to four-family residential real estate loans and home equity loans that are past due 90 days or more with loan-to-value ratios

2. For operational purposes, whenever a charge-off is necessary under this policy, it should be taken no later than the end of the month in which the applicable time period elapses. Any full payment received after the 120- or 180-day charge-off threshold, but before month-end charge-off, may be considered in determining whether the charge-off remains appropriate.

OTS regulation 12 CFR 560.160(b) allows savings institutions to establish adequate (specific) valuation allowances for assets classified loss in lieu of charge-offs.

Open-end retail accounts that are placed on a fixed repayment schedule should follow the charge-off time frame for closed-end loans.

1. [For the Federal Reserve's classification guidelines, see section 2060.1, "Classification of Credits."]

greater than 60 percent should be classified substandard. Properly secured residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status. Home equity loans to the same borrower at the same institution as the senior mortgage loan with a combined loan-to-value ratio equal to or less than 60 percent need not be classified. However, home equity loans where the institution does not hold the senior mortgage, that are past due 90 days or more should be classified substandard, even if the loan-to-value ratio is equal to, or less than, 60 percent.

- For open- and closed-end loans secured by residential real estate, a current assessment of value should be made no later than 180 days past due. Any outstanding loan balance in excess of the value of the property, less cost to sell, should be classified loss and charged off.
- Loans in bankruptcy should be classified loss and charged off within 60 days of receipt of notification of filing from the bankruptcy court or within the time frames specified in this classification policy, whichever is shorter, unless the institution can clearly demonstrate and document that repayment is likely to occur. Loans with collateral may be written down to the value of the collateral, less cost to sell. Any loan balance not charged off should be classified substandard until the borrower re-establishes the ability and willingness to repay for a period of at least six months.
- Fraudulent loans should be classified loss and charged off no later than 90 days of discovery or within the time frames adopted in this classification policy, whichever is shorter.
- Loans of deceased persons should be classified loss and charged off when the loss is determined or within the time frames adopted in this classification policy, whichever is shorter.

## Other Considerations for Classification

If an institution can clearly document that a past-due loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be classified. A well-secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property, includ-

ing securities with an estimable value, less cost to sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that amount. "In the process of collection" means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days.

## Partial Payments on Open- and Closed-End Credit

Institutions should use one of two methods to recognize partial payments. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing past-due status. Alternatively, the institution may aggregate payments and give credit for any partial payment received. For example, if a regular installment payment is \$300 and the borrower makes payments of only \$150 per month for a six-month period, [the institution could aggregate the payments received ( $\$150 \times$  six payments, or \$900). It could then give credit for three full months ( $\$300 \times$  three payments) and thus treat the loan as] three full months past due. An institution may use either or both methods in its portfolio, but may not use both methods simultaneously with a single loan.

## Re-aging, Extensions, Deferrals, Renewals, and Rewrites

Re-aging of open-end accounts, and extensions, deferrals, renewals, and rewrites of closed-end loans<sup>3</sup> can be used to help borrowers overcome

3. These terms are defined as follows. *Re-age*: Returning a delinquent, open-end account to current status without collecting [at the time of aging] the total amount of principal, interest, and fees that are contractually due. *Extension*: Extending monthly payments on a closed-end loan and rolling back the maturity by the number of months extended. The account is shown current upon granting the extension. If extension fees are assessed, they should be collected at the time of the extension and not added to the balance of the loan. *Deferral*: Deferring a contractually due payment on a closed-end loan without affecting the other terms, including maturity [or the due date for subsequently scheduled payments] of the loan. The account is shown current upon granting the deferral. *Renewal*: Underwriting a matured, closed-end loan generally at its outstanding principal amount and on similar terms. *Rewrite*: Underwriting an existing loan by significantly chang-

temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. A permissive policy on re-aging, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use is acceptable when it is based on a renewed willingness and ability to repay the loan, and when it is structured and controlled in accordance with sound internal policies.

Management should ensure that comprehensive and effective risk management and internal controls are established and maintained so that re-ages, extensions, deferrals, renewals, and rewrites can be adequately controlled and monitored by management and verified by examiners. The decision to re-age, extend, defer, renew, or rewrite a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that the institution's personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower has the ability to repay the loan. To be effective, management information systems should also monitor and track the volume and performance of loans that have been re-aged, extended, deferred, renewed, or rewritten and/or placed in a workout program.

## Open-End Accounts

Institutions that re-age open-end accounts should establish a reasonable written policy and adhere to it. To be considered for re-aging, an account should exhibit the following:

- The borrower has demonstrated a renewed willingness and ability to repay the loan.
- The account has existed for at least nine months.
- The borrower has made at least three consecutive minimum monthly payments or the equivalent cumulative amount. Funds may not be advanced by the institution for this purpose.

Open-end accounts should not be re-aged more than once within any twelve-month period and no more than twice within any five-year period. Institutions may adopt a more conservative re-aging standard; for example, some institutions allow only one re-aging in the lifetime of an open-end account. Additionally, an over-limit account may be re-aged at its outstanding balance (including the over-limit balance, interest, and fees), provided that no new credit is extended to the borrower until the balance falls below the predelinquency credit limit.

Institutions may re-age an account after it enters a workout program, including internal and third-party debt-counseling services, but only after receipt of at least three consecutive minimum monthly payments or the equivalent cumulative amount, as agreed upon under the workout or debt-management program. Re-aging for workout purposes is limited to once in a five-year period and is in addition to the once-in-twelve-months/twice-in-five-years limitation described above. To be effective, management information systems should track the principal reductions and charge-off history of loans in workout programs by type of program.

## Closed-End Loans

Institutions should adopt and adhere to explicit standards that control the use of extensions, deferrals, renewals, and rewrites of closed-end loans. The standards should exhibit the following:

- The borrower should show a renewed willingness and ability to repay the loan.
- The standards should limit the number and frequency of extensions, deferrals, renewals, and rewrites.
- Additional advances to finance unpaid interest and fees should be prohibited.

Management should ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained to support the collection process and to ensure timely recognition of losses. To be effective, management information systems should track the subsequent principal reductions and charge-off history of loans that have been granted an extension, deferral, renewal, or rewrite.

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ing its terms, including payment amounts, interest rates, amortization schedules, or its final maturity.

## Examination Considerations

Examiners should ensure that institutions adhere to this policy. Nevertheless, there may be instances that warrant exceptions to the general classification policy. Loans need not be classified if the institution can document clearly that repayment will occur irrespective of delinquency status. Examples might include loans well secured by marketable collateral and in the process of collection, loans for which claims are filed against solvent estates, and loans supported by valid insurance claims.

The Uniform Retail Credit Classification and Account Management Policy does not preclude examiners from classifying individual retail-credit loans that exhibit signs of credit weakness regardless of delinquency status. Similarly, an examiner may also classify retail portfolios, or

segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account-management practices that are deficient.

In addition to reviewing loan classifications, the examiner should ensure that the institution's allowance for loan and lease losses provides adequate coverage for probable losses inherent in the portfolio. Sound risk- and account-management systems, including a prudent retail-credit lending policy, measures to ensure and monitor adherence to stated policy, and detailed operating procedures, should also be implemented. Internal controls should be in place to ensure that the policy is followed. Institutions that lack sound policies or fail to implement or effectively adhere to established policies will be subject to criticism.

*Issued by the FFIEC on June 12, 2000.*

# Consumer Credit

## Examination Objectives

Effective date May 2003

## Section 2130.2

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1. To determine the quality and adequacy of operations (including the adequacy of lending policies, practices, procedures, internal controls, and management information systems) for consumer credit and credit card plans.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To evaluate the consumer credit portfolio for credit quality, performance, adequate collateral, and collectibility.
4. To determine the scope and adequacy of the audit and loan-review function.
5. To determine the level of risk inherent in a bank's consumer credit and credit card lending departments and what actions management has taken to identify, measure, control, and monitor the level and types of risks.
6. To determine that the goals and objectives of specific credit card plans are being achieved and that the plans are profitable.
7. To determine compliance with the board of directors' and senior management's policies and procedures and with applicable laws and regulations.
8. To initiate corrective action when policies, procedures, practices, or internal controls are deficient or when violations of law or regulations have been noted.



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GENERAL CONSUMER CREDIT

1. If selected for implementation, complete or update the installment loan section of the internal control questionnaire.
  2. Based on the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
  3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review conducted by internal or external auditors. If applicable, also determine if the latest consumer compliance examination disclosed any violation of laws or regulations. Determine if corrective action has been taken.
  4. Request that the bank supply the following:
    - a. a listing of all dealers who have indirect-paper, fleet-leasing, or discounted-lease lines, along with respective codes
    - b. an indirect paper or a fleet-leasing or discounted fleet-leasing report by code, along with the respective delinquency report for all loans past due 30 days or more
    - c. a listing of dealer reserves, holdback accounts, or both showing the dealer, account number, and balance
    - d. the latest month-end extension and renewal reports
    - e. a schedule of all loans with irregular or balloon payments or both
    - f. a schedule of all loans with more than five prepaid installments
    - g. a listing of loans generated by brokers or finders
    - h. a listing of current repossessions, including the name of the borrower, a description of the item, the date of repossession, the date title was acquired, and the balance
    - i. a copy of each monthly installment-loan charge-off report since the preceding examination (If the monthly reports do not include all the information necessary to support the charge-off of the installment loans, request a revised listing that includes the missing information for each charge-off.)
  - j. management reports that are prepared by department personnel and that are not forwarded in their entirety to the board of directors or its committee
  - k. a listing of the amount of recoveries on charged-off installment loans, by month, since the preceding examination
  - l. a listing of all outstanding loans that have been assigned to an attorney for collection
  - m. an identification of all columns and codes on the computer printout
5. Obtain a trial balance of installment loans. Use of the bank's latest trial balance is acceptable. If exact figures are required, update the trial balance from the daily transaction journals. Using the trial balance—
    - a. agree or reconcile balances to department controls and the general ledger and
    - b. review reconciling items for reasonableness.
  6. Using an appropriate sampling technique, select borrowers' loans to be reviewed during the examination.
  7. Using an appropriate technique, select indirect dealers and fleet-leasing and indirect-lease lines from indirect-dealer or leasing reports. Transcribe the following onto consumer finance indirect line cards:
    - a. the amount and number of contracts, indicating whether they are with or without recourse
    - b. the amount and number of contracts still accruing that are past due 30–89 days and 90 days or more
    - c. the balance in dealer reserve or holdback accounts or both
  8. Obtain the following schedules from the bank or the appropriate examiner if they are applicable to this area:
    - a. past-due loans (obtain separate schedules by branch, if available)
    - b. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
    - c. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination

- d. loan commitments and other contingent liabilities
  - e. extensions of credit to employees, officers, directors, principal shareholders, and their interests, specifying which officers are considered executive officers
  - f. correspondent banks' extensions of credit to executive officers, directors, and principal shareholders and their interests
  - g. a list of correspondent banks
  - h. miscellaneous loan debit-and-credit suspense accounts
  - i. loans considered "problem loans" by management
  - j. each officer's current lending authority
  - k. the current structure of interest rates
  - l. any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee
  - m. reports furnished to the loan and discount committee or any similar committee
  - n. reports furnished to the board of directors
  - o. loans classified during the preceding examination
  - p. the extent and nature of loans serviced
9. Review the information received and perform the following for—
- a. Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap:
    - Participations only:
      - Test participation certificates and records and determine that the parties share in the risks and contractual payments on a pro rata basis.
      - Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
    - Procedures pertaining to *all* transfers:
      - Investigate any situations in which loans were transferred immediately before the date of examination to determine if any were transferred to avoid possible criticism during the examination.
      - Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
      - Determine that low-quality loans transferred to or from the bank are properly reflected on its books at fair value (while fair value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium).
  - Determine that low-quality loans transferred to the parent holding company or a nonbank affiliate are properly reflected at fair value on the books of both the bank and its affiliate.
  - If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
    - (1) name of originating institution
    - (2) name of receiving institution
    - (3) type of transfer (i.e., participation, purchase/sale, swap)
    - (4) date of transfer
    - (5) total number of loans transferred
    - (6) total dollar amount of loans transferred
    - (7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
    - (8) any other information that would be helpful to the other regulator
  - b. Miscellaneous loan debit-and-credit suspense accounts:
    - Discuss with management any large or old items.
    - Perform additional procedures as considered appropriate.
  - c. For loan commitments and other contingent liabilities, if the borrower has been advised of the commitment and it exceeds the cutoff alone or in combination with any outstanding debt, prepare a line card for subsequent analysis and review.
  - d. For loans classified during the previous examination, determine the disposition

- of loans so classified by—
- obtaining current balances and their payment status, or the date the loan was repaid and source of payment;
  - investigating any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank or were a result of a participation, sale, or swap with another lending institution; and
  - referring to step 9a of this section for the appropriate examination procedures, determine if repayment was a result of a participation, sale, or swap.
- e. Select loans that require in-depth review on the basis of information derived from the above schedules.
10. Consult with the examiner responsible for the asset-liability management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources. See section 6000.1, “Instructions for the Report of Examination,” for considerations to be taken into account when compiling maturity information for the gap analysis.
  11. Obtain liability and other information on common borrowers from examiners assigned to overdrafts, lease financing, and other loan areas. Together decide who will review the borrowing relationship.
  12. Obtain the credit files of all direct non-consumer borrowers, indirect dealers, and fleet-leasing and discounted-leasing lines for which line cards have been developed. Transcribe and analyze the following as appropriate:
    - a. the purpose of the loan
    - b. collateral information, including its value and the bank’s right to hold and negotiate it
    - c. the source of repayment
    - d. ancillary information, including the type of business, its officers, and its affiliation
    - e. fiscal and interim financial exhibits
    - f. guarantors and the amount of any guarantee
    - g. personal statements of borrowers, endorsers, or guarantors
    - h. external credit checks and credit bureau reports
    - i. loan officer’s credit memoranda
    - j. subordination agreements
    - k. a corporate resolution to borrow or guarantee
    - l. provisions of the loan agreement or master lease agreement
    - m. the type of dealer endorsement:
      - full recourse
      - limited recourse
      - nonrecourse
    - n. dealer repurchase agreements
    - o. reserve and holdback requirements
    - p. the amount of insurance coverage
  13. Check the central liability file on borrowers indebted above the cutoff or borrowers displaying credit weakness who are suspected of having additional liability in other loan areas.
  14. Transcribe significant liability and other information on officers, principals, and affiliations of borrowers for which line cards have been developed. Cross-reference, if appropriate.
  15. Review a listing of loans generated by brokers or finders:
    - a. Check the quality of the paper being acquired.
    - b. Determine that sufficient financial data have been obtained to support the credits.
    - c. Evaluate performance.
  16. Review the current past-due (delinquent) loan list and determine that loans are aged using the contractual method, which ages a loan on the basis of its contractual repayment terms, as required by the Call Report instructions. Discuss with management selected delinquent loans from the listings of delinquent loans and repossessed collateral.
  17. Determine if management has a general policy for the timely classification and charge-off of past-due loans and ascertain whether the policy is adhered to. Determine if loan-classification practices follow the board of directors’ respective policies. Ascertain whether those policies comply with the provisions of the FFIEC’s Uniform Retail Credit Classification and Account Management Policy and with Federal Reserve policy. Review with management individual accounts that have not been charged off in line with these policies.
  18. Review voluntary charge-offs made since the preceding examination and, on a test basis, review files on borrowers and ascertain the correctness of the charge-off.
  19. Review any reports being submitted on

delinquent and defaulted loans guaranteed by government agencies:

- a. Determine that management is informed accurately and is complying with the reporting requirements.
- b. Determine that claims are being promptly filed after default.

## OVERDRAFT-PROTECTION PROGRAMS

1. Determine if the bank has developed and implemented adequate written overdraft-protection-program policies and procedures for its ad hoc, automated, and other overdraft programs. Determine if the policies and procedures comply with the February 18, 2005, interagency Joint Guidance on Overdraft Protection Programs.
2. Ascertain whether the bank's management emphasizes and monitors adherence to its overdraft policies and procedures, applies generally accepted accounting principles to overdraft transactions, and applies the bank Call Report's accounting and reporting instructions and requirements to overdrafts. Evaluate whether the bank maintains and monitors safe and sound overdraft business practices to control the credit, operational, and other risks associated with overdraft programs.
3. Apply the additional examination procedures for overdraft-protection programs (see section 3000.3) when weaknesses are found in (1) the bank's compliance with the February 2005 interagency guidance and (2) the bank's evaluation of the risks associated with overdraft-protection programs.

## CREDIT CARD LENDING

The examiner's analysis of operating policies and procedures is key to the examination of credit card banks and credit card operations. Credit card lending is characterized by a high volume of accounts, homogeneous loan pools, and small-dollar balances. A concentrated review of individual accounts, therefore, may not be practical. Examination procedures should focus on evaluating policies, procedures, and internal controls in conjunction with performing other selected functions. The goal is not confined to

identifying current portfolio problems. The examination process should include an investigation of potential problems that may result from ineffective policies, unfavorable trends, lending concentrations, or nonadherence to policies. The following examination procedures should be performed.

1. Review UBPR data to determine the volume of credit card activity.
2. Determine if management has recently offered or plans to offer new products or if management plans to enter new market niches or expand the credit card portfolio significantly (new offerings may include affinity cards, co-branded cards, secured cards, or purchasing cards).
3. Determine whether the bank is engaged or plans to engage in subprime credit card lending. If subprime lending exists or is planned, perform the subprime-lending examination procedures in section 2133.3.
4. Review correspondence that the bank has received or exchanged with credit card networks (i.e., Visa, MasterCard). These agencies perform periodic reviews of their members.

## Policy Considerations

1. Review the credit card policy. Policy guidelines should include the following items:
  - a. adequate screening of account applicants
  - b. standards for approving accounts and determining credit-line size
  - c. minimum standards for documentation
  - d. internal controls to prevent and detect fraud, such as—
    - review procedures, including frequent review of delinquent accounts;
    - delinquency notification and collection procedures;
    - criteria for freezing accounts and charging off balances;
    - criteria for curing and re-aging delinquent accounts;
    - controls to avoid reissuances of expired cards to obligors who have unsatisfactory credit histories;
    - approvals of and controls over over-limits and overrides; and
    - cardholder information security controls
  - e. due diligence before engaging the service of a third party, as well as the

ongoing management of credit card operations

## Audit

1. Review the adequacy of the audit function regarding credit card operations.
  - a. Determine if the audit program identifies contraventions of internal policy, credit card network (i.e., Visa, MasterCard) regulations, and written contracts.
  - b. Determine if audit procedures include reviewing the accuracy and integrity of the bank's system for reporting the past-due status of credit card loans, over-limit accounts, and other management information systems.
  - c. Determine if audit procedures include reviewing computer-driven models.
  - d. Determine if independent tests of automated procedures are performed (for example, a sample of automatically re-aged accounts may be independently reviewed to test the integrity of automated systems).
  - e. Determine whether audit procedures include a review of credit card processing operations. Ascertain if the product control file governing credit card processing was reviewed and whether it revealed any significant internal control weaknesses, such as a lack of segregation of duties and access controls. Determine whether management is aware of the risks and if the audit staff has the expertise to adequately evaluate procedures and suggest controls commensurate with the risks.
  - f. Determine if audit procedures include a review of the services provided by outside vendors (services such as telemarketing, data processing, and direct mail). Ascertain if the audit procedures included a review of the performance of the vendors and documentation of the relationships.
2. Determine if management has reviewed and appropriately responded to audit findings regarding credit card operations.

## Fraud

1. Evaluate management's strategy for control-

ling fraud, including whether the strategies frequently emphasize review of credit card applications to prevent fraudulent accounts from being booked or whether neural networks are used to identify fraudulent transactions. Common controls include the following items:

- a. methods of preventing application fraud, such as name and address verification, duplicate-application detection, Social Security number verification, etc.
  - b. physical aspects of cards such as holograms and enriched information on the magnetic stripe
  - c. adequate staffing and training of the fraud-detection department
  - d. computer systems to identify suspicious activity
  - e. procedures for issuing cards to prevent their interception and activation
  - f. procedures for handling returned cards, statements, PINs, checks, and lost and stolen cards
  - g. investigation and documentation of cases of suspected fraud
  - h. freezing of accounts with suspicious activity
  - i. procedures for filing a Suspicious Activity Report by Depository Institutions (SAR-DI) (See SR-07-2 and the attached June 2007 SAR-DI form, the requirements for suspicious-activity reporting in section 208.62 of the Board's Regulation H (12 CFR 208.62), and the Bank Secrecy Act compliance program in section 208.63 (12 CFR 208.63).)
  - j. procedures for access to and alteration of customer information
  - k. controls over cardholder payments, account-balance records, and charge-back administration
  - l. account-authorization procedures
2. Determine whether management receives adequate fraud-monitoring reports, such as—
    - a. out-of-pattern-purchase or sequence-of-purchase reports that identify suspicious transactions that do not fit an individual cardholder's established purchasing pattern or
    - b. suspicious-purchasing-pattern reports that identify certain types of purchases, such as electronics or jewelry, that can correlate with fraudulent activity.
  3. Review consumer complaint correspon-

dence from cardholders that is on file with the bank or primary federal regulator for irregularities or patterns of activity.

## Account Solicitation

1. Determine management's general approach to account solicitations (a variety of approaches or a combination of approaches can exist). Solicitations may be for preapproved or non-preapproved accounts. The latter are usually solicited through mass mailings, telemarketing, or counter displays.
2. Determine the extent to which outside contractors are used in marketing programs (for example, outsourced mass-mailing and telemarketing operations).
3. Review management's product and marketing program, including the goals of the program, the basis of the marketing approach, and product pricing. Ascertain whether adequate supporting evidence exists to indicate (1) that management has a marketing program and a product that appeal to the bank's targeted markets and (2) that the projected product and marketing program results will be obtained.
4. Determine how management identifies markets for new solicitations and evaluates expected performance.
  - a. Identify the analytical procedures (for example, response rates, usage rates, credit-score distributions, and future delinquency and loss rates) management uses to project the results of a particular solicitation.
  - b. Determine how management verifies projections before proceeding with a full-scale solicitation program (test marketing).
5. Determine if management monitors solicitation results for each major account segment and if management incorporates the findings into future solicitations.
6. Determine if management monitors and responds to trends in adverse selection (such as when a disproportionate number of respondents that are poor credit risks answer an offer, which may result in a larger-than-projected percentage of riskier accounts being included in the solicitation-response pool).
7. Review affinity and co-branding relationships. Determine if the bank has control

- over the approval and acceptance of such accounts. (In co-branding, a third-party relationship exists between a broad base of cardholders and a jointly sponsored credit card. Usually, the sponsors are the bank and a retail merchant for the affinity and co-branding relationships. These cards have some type of value-added feature such as cash rebates or discounts on merchandise.)
8. Review new-product offerings and the adequacy of management's market identification, testing, and ongoing monitoring of new products. Ascertain if management monitored and controlled key new-product concerns, including whether—
    - a. the amount of historical and test-sample data available to analyze the product or solicitation was adequate;
    - b. the speed at which the new product was introduced was compatible with the internal controls for credit authorizations; and
    - c. the size of solicitations introduced was adequately controlled, considering operational and managerial capabilities.
  9. Determine if management had any problems with the wording of solicitations or applications and if any imprecise offer terms contributed to asset-quality and earnings problems. Ascertain if there were errors such as the following:
    - a. no expiration date on the offer
    - b. an absence of wording giving management discretion in setting credit lines
    - c. insufficient information requirements on applications
  10. Review balance-transfer policies and monitoring practices. Determine if balance transfers generally resulted in higher credit exposures and a tendency to distort financial condition and performance ratios due to the immediate booking of relatively large balances.
  11. Review teaser interest-rate practices. Determine if controls are adequate to prevent teaser rates from disguising a borrower's repayment capacity and from resulting in higher attrition when the teaser rates expire.

## Predictive Models

1. Review the integrated models management uses to identify and select prospective cus-

tomers. (Management usually uses two distinct credit card predictive models. The first model, the credit-scoring model, is used in the initial application process. The second model, a behavioral model, is used in the management of existing accounts. These models use a credit scorecard, which is a table of characteristics, attributes, and scores that enable a credit grantor to calculate default risk. Information derived from these models assists management with quantifying and minimizing credit risk and fraud losses.)

## Credit Scoring

1. Determine the nature and extent that credit scores are used in the underwriting process.
2. Determine the degree of reliance placed on credit bureau score “good” and “bad” odds charts. Ascertain if management develops and calibrates its own good and bad odds chart with a sufficient quantity and quality of historical account data (a customized odds chart is more predictive than a credit bureau odds chart).
3. Determine if a single- or dual-score model is used. (A single-score model uses credit bureau scores; a dual-score matrix calculates a score based on the combination of a custom score, usually based on credit application data, and a credit bureau score. For the more complex operations, management should be using the more sophisticated dual-scoring model.)



## Behavior-Scoring System

1. Determine whether management has implemented a behavior-scoring system to manage existing accounts. (The score is derived from a cardholder's payment and usage behavior with the credit cardholder's issuing bank. A cardholder's historical performance with a particular bank is typically the best indicator of future performance with that bank. Behavior scores are frequently supplemented with credit bureau scores to enhance their predictive value.)
2. Ascertain if management continually refines existing, or if it considers new, predictive models.
  - a. Determine whether a champions and challengers system is used. (Such a system involves continual portfolio analysis and identification of predictive characteristics. Based on this analysis, existing models are revised and enhanced. The revised challenger model is then compared with the existing champion model. If the challenger is more predictive, it is adopted. This procedure is an ongoing system of refinement.)
  - b. Determine if management has adopted or is considering new predictive models (for example, revenue, revolving, bankruptcy, and payment-predictor models).

## Validation

1. If credit scoring is used, determine if management is validating scores by comparing account-quality rankings of accepted applications with those predicted by the system (when the rank orderings remain substantially the same, the scoring system remains valid).
  - a. Review the statistical techniques used to validate each model used, and determine whether common statistical techniques are being used, such as the K/S test, the chi square, the goodness-of-fit test, divergence statistics, and the population stability test.
  - b. Determine if high and low override controls are in place and if they are detailed on exception reports (overrides can skew a statistical population and distort analysis).

## Portfolio Analysis

1. Review and analyze the bank's customized credit card reports, which usually include performance and industry peer-group analysis data (be alert to the possibility that the data may have been distorted by niche marketing, specialized card products, or extensive affiliate support).
2. Determine if management is segmenting portfolios (such as by geographic or demographic distribution, affinity relationship (cardholders belonging to a particular union, corporation, professional association, etc.), product type (premium or standard cards), or credit bureau scores). Consider the particular characteristics of each segment for delinquency, profitability, future marketing programs, ALLL calculations, and other purposes.
3. Determine whether geographic, customer-base, card-type, or other concentrations exist, and identify the unique risks posed by any of these portfolio segments or concentrations. Evaluate their degree of risk and consider mitigating factors.
4. Review how management uses portfolio information to identify developing trends, make strategic decisions, and detect potential problems.
  - a. Determine how management reports identify the number and volume of workout and re-aged credits.<sup>1</sup>
  - b. Evaluate the portfolio information that management reviews, such as asset-quality ratios and vintage analysis (an analysis of the account performance of homogeneous loans booked at a similar time using the same credit and pricing criteria).
5. Determine if cash advances are monitored and authorization procedures are in place

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1. A workout is a former open-end credit card account in which credit availability has been closed and in which the balance owed has been placed on a fixed (dollar or percentage) repayment schedule in accordance with modified, concessionary terms and conditions. Generally, the repayment terms require amortization or liquidation of the balance owed over a defined payment period. Such arrangements are typically used when a customer is either unwilling or unable to repay the open-end credit card account in accordance with the original terms but shows the willingness and ability to repay the loan in accordance with modified terms and conditions. In a re-aged credit account, the bank changes the delinquency status of an account without the full collection of its delinquent payments.



- (cardholders with excessive debt may obtain cash advances to pay other debts).
6. Review the level and trend of the following portfolio ratios:
    - a. average balance of delinquent accounts (by 30-day time frames) to average balance of nondelinquent accounts
    - b. lagged delinquency rate and nine-month net charge-offs to lag rates
    - c. net charge-off rate and lagged net charge-off rate
    - d. re-aged accounts and partial-payment plans to total active accounts and to average total loans
    - e. total past-due loans to gross loans
    - f. noncurrent loans to gross loans
  7. Consider indicators of possible deterioration in asset quality and criticize prolonged practices that result in negative amortization (that is, when minimum payments consistently fall short of covering all finance charges and fees assessed during the billing cycle and when the outstanding balance continues to increase), inappropriate fees, and other practices that inordinately compound or protract consumer debt and disguise portfolio performance and quality. Be alert to other indicators and practices that can reflect a deterioration of asset quality, such as—
    - a. rapid growth that may indicate a lowering of underwriting standards;
    - b. lower minimum-payment requirements and extended principal-payment cycles, which may result in negative amortization and may also indicate less creditworthy accounts;
    - c. a heightened ratio of total accounts being charged off to the number of accounts or a high average balance of accounts that may indicate a lax policy toward the number and level of credit lines granted to cardholders;
    - d. lower payment rates combined with higher average balances, which may indicate that borrowers are having trouble paying their debt;
    - e. an inordinately high ratio of income earned not collected on loans to total loans when compared with the percentage of total past-due loans to gross loans, which may indicate frequent re-aging, inadequate collection procedures, or a failure to charge off credit card receivables on a timely basis; and
    - f. the average age of accounts, which may indicate that loss rates will rise for unseasoned accounts (loss rates are usually low for new offerings and peak at 18 to 24 months after issue).
  8. Evaluate management's practices for cure programs, such as re-aging, loan extensions, deferrals, fixed payment, and forgiveness.
  9. Develop an overall assessment of the adequacy of a bank's account-management practices for its credit card lending business, incorporating the risk profile of the bank, the quality of management reporting, and the adequacy of the bank's charge-off policies and loss-allowance methodologies.
  10. Evaluate whether the bank clearly documents in its policies and procedures the basis for using the exceptions to the FFIEC Uniform Retail Credit Classification and Account Management Policy and whether the bank documents the types of exceptions used and the circumstances giving rise to their use. Determine if the bank prudently limits the use of exceptions. If it does not, criticize the bank's management and require corrective action when the exceptions are not well managed, result in improper reporting, or mask delinquencies and losses.
  11. Criticize management and recommend appropriate supervisory corrective action when workout programs are not managed properly (characteristics of improperly managed workout programs include workout programs that do not strive to have the borrowers repay credit card debt within 60 months, the existence of liberal repayment terms with extended amortizations, high charge-off rates, accounts being moved from one workout program to another, multiple re-aging, and poor MIS to monitor program performance).
  12. Determine that the bank complies with the FFIEC Uniform Retail Credit Classification and Account Management Policy.
  13. Determine whether management monitors and analyzes the performance of each workout program (whether the program achieves the objective of improving the borrower's subsequent performance, the effect of the program on delinquency ratios, etc.)
  14. Assess the current and potential impact the workout programs have on reported performance and profitability, including their ALLL implications.
  15. Determine if third parties purchase or fund

- loan payments to cure loan delinquencies and, if so, assess the impact.
16. Determine whether management developed contingent strategies to deal with rising delinquency levels, which are generally the first sign of account deterioration. Strategies could include the following issues:
    - a. reviewing accounts more frequently
    - b. decreasing the size of credit lines
    - c. freezing or closing accounts
    - d. increasing collection efforts
  17. Ascertain the bank's compliance with its credit card policies and procedures by reviewing a sample of the bank's credit card loans that were originated since the prior examination.
  18. Determine the level of classifications for credit card loans:
    - a. Review a sample of loans to ascertain the accuracy and integrity of the bank's system for reporting past-due status.
    - b. Verify that the bank's classification and charge-off procedures adhere to, at a minimum, the guidance of the FFIEC Uniform Retail Credit Classification and Account Management Policy.
3. Determine if ALLL calculations are comprehensive and if they consider the following factors:
    - a. contingent liabilities, or the risk associated with undisbursed funds
    - b. bankrupt and deceased cardholders (such losses are usually not predicted by a simple roll-rate analysis)
    - c. economic conditions, such as unemployment and bankruptcy rates, that can significantly affect asset quality
    - d. the number and volume of workout and re-aged credits
  4. Determine if the ALLL methodologies adequately provide for the use of cure programs, settlement arrangements,<sup>2</sup> workout programs, existing over-the limit portfolio segments, any resulting estimable probable losses on those accounts, and any other credit card loan accounts.
  5. Review the accounting practices for credit- ing recoveries on credit card loans. Determine that the total amount credited to the ALLL as recoveries on individual credit card loans is limited to the amounts previously charged off against the ALLL for the credit card loan. Any excess recovery amount must be recognized as income.
  6. Verify that fraud losses are not charged to the ALLL or included in ALLL calculations and that the losses are recorded as a non- interest expense.

## Allowance for Loan and Lease Losses

1. Ascertain whether an allowance for loan and lease losses (ALLL) policy exists for credit card loans and if adequate ALLL analytical procedures are in place. Roll-rate analysis (analysis of the migration of an account from one billing cycle to the next), which is generally performed for each portfolio segment, is the industry standard. However, some banks use the following additional or alternative methods:
  - a. delinquency analysis using a set percentage of loans over 60 days delinquent
  - b. exposure analysis that projects net charge-off rates to each 30-day period of delinquency
  - c. charge-off projections based on vintage analysis
  - d. a historical rolling average based on charge-off rates for the last six months
  - e. analysis based on external economic forecasting services
2. Review ALLL-calculation techniques for reasonableness (variables such as aggregating seasoned and unseasoned portfolios can

## Asset Securitization

Perform the following examination procedures when the bank has securitized its credit card receivables (removed designated credit card receivables from its balance sheet to a special-purpose vehicle (SPV) while the bank retains its account ownership).

1. Determine if the credit card loan delinquency and loss rates are similar for both the owned portfolio and the securitized portfolio. (Slightly higher delinquency and net charge-off ratios on securitized assets

<sup>2</sup> In a settlement arrangement, the bank forgives a portion of the amount owed. In exchange, the borrower agrees to pay the remaining balance either in a lump-sum payment or by amortizing the balance over several months.

will be prevalent if the bank is experiencing high growth and possesses a significant portion of unseasoned accounts.) When the delinquency and loss rates deviate significantly, determine if management is prioritizing credit card receivables for securitization by selecting credit card accounts that have either a high credit quality or superior past credit history. For example, in the following two ratios, the resulting percentages on a managed and owned basis should approximate one another: (1) noncurrent loans to gross loans and (2) total past-due loans to gross loans.

2. Determine the on- and off-balance-sheet effects of asset securitization. (For example, what is the on- and off-balance-sheet effect of removing seasoned accounts?) (A performance analysis is important because the level of a credit card bank's earnings and capital is largely dependent on the quality of its average total assets under management and not merely on the owned credit card portfolio.)

### Third Parties

1. Determine whether any credit card-related activities are outsourced. If so, complete the third parties review located in the Subprime Lending Loan Reference. Third parties may include brokers, marketing firms, collection or servicing firms, correspondents, affinity partners, and information systems firms.
2. Determine whether the bank shares a BIN (bank identification number) with a third party. (Sharing of BINs can create financial liability. A bank sharing a BIN should have a process to identify, monitor, and control the risks associated with BIN sharing. Certain Visa and MasterCard members are assigned BINs (represented by a series of numbers on the credit card) for clearing and settlement of their credit card activities. Members that are licensed specific BINs may allow other members to deposit and receive transactions through those BINs. However, the BIN licensee (holder of the BIN) has primary responsibility for transactions processed through its BIN. In addition, users of a BIN other than the BIN licensee (BIN holder) may share responsibility for transactions processed under that

BIN if the licensee fails to meet its membership obligations.)

## BANK POLICIES AND PROCEDURES AND STATUTORY AND REGULATORY REQUIREMENTS

1. Determine compliance with laws, regulations, and Federal Reserve Board policies pertaining to lending by performing the following steps.

- a. *Lending limits:*

- Determine the bank's lending limits as prescribed by state law.
- Determine advances or combinations of advances whose aggregate balances are above the limit.

- b. *Sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 371c-1) and the Federal Reserve's Regulation W—Transactions with Affiliates:*

- Obtain a listing of loans and other extensions of credit to affiliates.
- Test-check the listing against the bank's customer liability records to determine the list's accuracy and completeness.
- Obtain a listing of other covered transactions with affiliates (i.e., purchase of an investment or securities issued by an affiliate; purchase of loans or other credit-related assets, including assets subject to an agreement to repurchase from an affiliate; the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate; or acceptance of affiliate's securities as collateral for a loan to any person).
- Determine the volume of transactions with third parties when the proceeds were used or transferred for the benefit of any affiliate.
- Ensure that covered transactions with affiliates do not exceed the limits of section 23A.
- Ensure that covered transactions with affiliates meet the collateral requirements of section 23A.
- Determine that low-quality loans or other assets have not been purchased from an affiliate.

- Determine that all transactions with affiliates are on market terms and conditions that are consistent with safe and sound banking practices.
  - Determine that the transactions were conducted on terms and conditions that reflect pricing that is generally available to unaffiliated parties.
- c. *18 USC 215—Commission or Gift for Procuring Loan:*
- While examining the installment loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
  - Investigate any such suspected situation.
- d. *Federal Election Campaign Act (2 USC 441b)—Political Contributions:*
- While examining the installment loan area, determine the existence of any loans in connection with any election to any political office.
  - Review each such credit to determine whether it is made in accordance with applicable banking laws and regulations and in the ordinary course of business.
- e. *12 USC 1972—Tie-In Provisions.* While reviewing credit and collateral files (especially loan agreements), determine whether any extension of credit is conditioned upon the customer's—
- obtaining additional credit, property, or services from the bank, other than a loan, discount, deposit, or trust service;
  - obtaining additional credit, property, or service from the bank's parent holding company or the parent's other subsidiaries;
  - providing an additional credit, property, or service to the bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;
  - providing additional credit, property, or service to the bank's parent holding company or any of the parent's other subsidiaries; or
  - not obtaining other credit, property, or service from a competitor of the bank, the bank's parent holding company, or the parent's other subsidiaries, except that the lending bank may impose conditions and requirements in a credit transaction to ensure the soundness of the credit.
- f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider activities and reporting requirements are as follows (the examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment):
- *Regulation O (12 CFR 215)—Loans to Executive Officers, Directors, and Principal Shareholders and Their Interests.* While reviewing information relating to insiders received from the bank or appropriate examiner (including information on loan participations, loans purchased and sold, and loan swaps)—
    - Test the accuracy and completeness of information about installment loans by comparing it with the trial balance or loans sampled.
    - Review credit files on insider loans to determine that required information is available.
    - Determine that loans to insiders do not contain terms more favorable than those afforded to other borrowers.
    - Determine that loans to insiders do not involve more than the normal risk of repayment or present other unfavorable features.
    - Determine that loans to insiders, as defined by the various sections of Regulation O, do not exceed the lending limits imposed by those sections.
    - If prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained.
    - Determine compliance with the various reporting requirements for insider loans.
    - Determine that the bank has made provisions to comply with the public disclosure requirements for insider loans.

- Determine that the bank maintains records of such public requests and the disposition of the requests for a period of two years.
  - *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2))—Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
    - Obtain from or request that the examiners reviewing due from banks and deposit accounts verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
    - Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.
  - g. *Federal Reserve Board Policy Statement on the Disposition of Credit Life Insurance Income (67 Fed. Res. Bull. 431 (1981), FRRS 3–1556).* Test for compliance with the policy statement by determining—
    - that the income generated from the sale of credit life, health, and accident insurance<sup>3</sup> is—
      - not distributed directly to employees, officers, directors, or principal shareholders in the form of commissions or other income for their personal profit; however, such individuals may participate in a bonus or incentive plan in an amount not exceeding, in any one year, 5 percent of the recipient’s annual salary, and paid not more often than quarterly; and
      - for accounting purposes, credited to the bank’s income account, the income account of an affiliate operating under the Bank Holding Company Act, or in the case of an individual shareholder, to a trust for the benefit of all shareholders.
    - whether an insurance agent or agency acted as an intermediary in arranging the bank’s credit life insurance coverage and what the relationship of the agent or agency is to the bank. Is the agent or agency in compliance with the provisions of this policy?
  - which employees, officers, directors, and principal shareholders are licensed insurance agents.
  - whether bank officers have entered into reciprocal arrangements with officers of other banks to act as agent for sale of credit life insurance and to receive commissions.
  - if the credit life insurance income is credited to an entity other than the bank and whether the bank is being appropriately reimbursed for the use of its premises, personnel, and goodwill. Compute the percentage compensation paid to the bank (total credit life insurance income). Include that percentage in the confidential section of the commercial report of examination. As a general rule, a reasonable compensation would be an amount equivalent to at least 20 percent of the credited entity’s *net* income (if available) attributable to the credit life insurance sales.
  - h. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103.33)—Records to Be Retained by Financial Institutions.* Review operating procedures and credit life documentation and determine whether the bank retains records of each extension of credit over \$10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date therefor. Loans secured by an interest in real property are exempt.
2. Perform appropriate procedural steps for the separate area, concentration of credits.
  3. Discuss with the appropriate officer (or officers) and prepare comments to the examiner-in-charge stating your findings on the following:
    - a. delinquent loans, including breakout of “A” paper
    - b. violations of laws and regulations
    - c. concentration of credits
    - d. classified loans
    - e. loans not supported by current and complete financial information
    - f. loans on which collateral documentation is deficient

3. This policy also applies to income derived from the sale of mortgage life insurance; therefore, consult with the examiner assigned real estate loans to coordinate work to avoid any duplication of efforts.

- g. inadequately collateralized loans
  - h. extensions of credit to major stockholders, employees, officers, directors, and/or their interests
  - i. Small Business Administration or other government-guaranteed delinquent or criticized loans
  - j. a list of installment loans requested to be charged off
  - k. the adequacy of written policies relating to installment loans
  - l. the manner in which bank officers are operating in conformance with established policy
  - m. adverse trends within the installment area
  - n. the accuracy and completeness of the schedules obtained from the bank or other examination areas
  - o. internal-control deficiencies or exceptions
  - p. recommended corrective action when policies, practices, or procedures are deficient
  - q. the quality of departmental management
  - r. other matters of significance
4. Update the workpapers with any information that will facilitate future examinations.

# Consumer Credit

## Internal Control Questionnaire

Effective date May 2005

Section 2130.4

Review the bank's internal controls, policies, practices, and procedures for making and servicing installment loans. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. In the questionnaire below, items marked with an asterisk require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written installment-loan policies that establish—
  - a. procedures for reviewing installment-loan applications?
  - b. standards for determining credit lines?
  - c. minimum standards for documentation?
2. Are installment-loan policies reviewed at least annually to determine if they are compatible with changing market conditions?
3. Does the bank have adequate written overdraft-protection-program policies and procedures that follow the February 28, 2005, interagency Joint Guidance on Overdraft Protection Programs?
4. Does the bank's management emphasize and monitor adherence to its overdraft policies and procedures, apply generally accepted accounting principles, and apply the bank Call Report's accounting and reporting requirements to overdrafts? Does the bank maintain and monitor safe and sound overdraft business practices to control the credit, operational, and other risks associated with overdraft programs?

### RECORDS

- \*1. Is the preparation and posting of subsidiary installment-loan records performed or reviewed by persons who do not also—
  - a. issue official checks or drafts?
  - b. handle cash?
- \*2. Are the subsidiary installment-loan records reconciled daily to the appropriate general ledger accounts, and are reconcil-

ing items investigated by persons who do not also handle cash?

3. Are delinquent-account collection requests and past-due notices checked to the trial balances that are used in reconciling installment-loan subsidiary records to general ledger accounts, and are requests and notices handled only by persons who do not also handle cash?
4. Are loan-balance inquiries received and investigated by persons who do not also handle cash?
- \*5. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash? (If not, explain why briefly.)
6. Is a daily record maintained that summarizes loan-transaction details, i.e., loans made, payments received, and interest collected, to support applicable general ledger account entries?
7. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?
8. Are two authorized signatures required to effect a status change in an individual customer's account?
9. Does operating management produce and review an exception report that encompasses extensions, renewals, or any factors that would result in a change in a customer's account status?
10. Do customer account records clearly indicate accounts that have been renewed or extended?

### LOAN INTEREST

1. Is the preparation and posting of interest records performed or reviewed by persons who do not also—
  - a. issue official checks or drafts?
  - b. handle cash?
2. Are any independent tests of loan-interest computations made and compared with initial and subsequent borrowers' interest records by other persons who do not—
  - a. issue official checks or drafts?
  - b. handle cash?

## COLLATERAL

## DEALER LOANS

1. Are multicopy, prenumbered records maintained that—
  - a. detail the complete description of collateral pledged?
  - b. are typed or completed in ink?
  - c. are signed by the customer?
2. Are receipts issued to customers for each item of collateral deposited?
3. Are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?
4. Is negotiable collateral held under joint custody?
5. Is all collateral for a single loan maintained in a separate file?
6. Are receipts obtained and filed for released collateral?
7. Is a record maintained of entry to the collateral vault?
8. Are the following controls on collateral in effect:
  - a. When the bank customers' savings pass-books are held as collateral, the savings department is notified and the account is so noted on the deposit ledger.
  - b. Descriptions of motor vehicles, as set forth on the certificate of title and insurance policies, are checked to the chattel mortgages or other appropriate documents granting security interest in the vehicle.
  - c. An insurance-maturity tickler file is maintained.
  - d. Procedures are in effect to ensure single-interest insurance coverage is obtained in case regular insurance is canceled or expires.
  - e. All insurance policies on file include a loss-payable clause in favor of the bank.
  - f. Filings are made on all security agreements.
  - g. Supporting lien searches and property appraisals are performed when a judgment action is returned involving real property.
9. Are control records maintained that identify loans secured by junior liens on real estate?
10. Do those records indicate the current balance for loans secured by superior liens on the same property?

1. On dealer loans, are—
  - a. separate controls maintained or can they be easily generated?
  - b. payments made directly to the bank and not through the dealer?
  - c. coupon books, if used in connection with loans, mailed to the borrowers, instead of the dealer?
  - d. monthly summaries of the total paper discounted and outstanding for each dealer prepared and reviewed?
  - e. dealer lines reaffirmed at least annually?
  - f. required documents on file in connection with the establishment of each dealer line?
  - g. signed extension agreements obtained from dealers before extending accounts originally discounted on a repurchase agreement or other recourse basis?
  - h. downpayment amounts checked to ensure they do not misrepresent the sales price?
  - i. procedures in effect to prevent the dealer from making late payments?
  - j. prohibitions against bringing loans current by charges to the dealer's reserve accounts in effect?
  - k. selling prices, as listed by the dealer, verified?
  - l. overdrafts prohibited in the dealer reserve and holdback accounts?
  - m. procedures in effect to have the title application controlled by someone other than the purchaser?
  - n. credit checks on borrowers performed independently of the dealer, or are the dealer's credit checks independently verified?
  - o. delinquencies verified directly with the customers?

## DISCOUNTED LEASING PAPER

1. If the bank discounts leasing paper—
  - a. are separate controls maintained or can they be easily generated?
  - b. are payments made directly to the bank?
  - c. are controls established or are audits of lessor's books conducted if the lessor is permitted to accept payments (if so, explain why briefly)?
  - d. are monthly summaries of total paper



- discounted for each lessor prepared and reviewed?
- e. are lines for each lessor reaffirmed at least annually?
  - f. is a master lease required and properly recorded when fleet-leasing or blanket purchase of leasing paper is handled?
  - g. is the value of leased goods verified to ensure that it is not less than the amount advanced?
  - h. is lease paper screened for the credit quality of the lessee?
  - i. are lease terms and payment amounts required to be adequate to liquidate the debt in full?
4. Do the bank's policies and procedures require that minimum payments on credit card accounts amortize the current balances over a reasonable period of time, consistent with the nature of the underlying debt and the borrower's documented creditworthiness? Do the bank's policies and practices foster or encourage prolonged negative amortization, inappropriate fees, and other practices that inordinately compound or protract consumer debt?
  5. Are workout programs designed to maximize principal reduction, and do they strive to have borrowers repay their credit card debt within 60 months? Has the bank documented and supported, with compelling evidence, any exceptions to the 60-month time frame for workout programs? Has the bank also documented and supported any less conservative loan terms and conditions that may be warranted?

## CREDIT CARD LENDING

1. Has the bank tested, analyzed, and documented line-assignment and line-increase criteria prior to broad implementation of a new credit card plan?
2. Is a borrower's repayment capacity carefully considered when the bank assigns an initial credit line or significantly increases existing credit lines?
  - a. Are credit-line assignments managed conservatively using proven credit criteria?
  - b. Does the bank have documentation and analyses of decision factors such as repayment history, risk scores, behavior scores, or other relevant criteria?
  - c. Does the bank consider its entire relationship with a borrower when making decisions about credit-line assignments?
  - d. If the bank offers multiple credit lines to borrowers, does it have sufficient controls and management information systems to aggregate related exposures and analyze borrowers' performance before offering them additional lines of credit?
3. Do the bank's policies and procedures focus on adequate control, authorizations, and the timely repayment of amounts that exceed established credit limits?
  - a. Are the bank's management information systems sufficient to enable management to identify, measure, manage, and control the risks associated with over-limit accounts?
  - b. Does the bank have appropriate policies and controls for over-limit authorizations on open-end accounts, particularly subprime accounts?
4. Does the bank evaluate the collectibility of accrued interest and fees on credit card accounts and recognize and properly account for the amounts that are uncollectible?
  - a. Are appropriate methods employed to ensure that income is accurately measured (such methods include providing loan-loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status)?
  - b. Is the owned portion of accrued interest and fees, including related estimated losses, accounted for separately from the retained interest in accrued interest and fees from securitized credit card receivables?
5. Does the bank's allowance for loan and lease losses (ALLL) methodology fully recognize the incremental losses that may be inherent in over-limit accounts and portfolio segments?

9. Are accounts in workout programs segregated for performance-measurement, impairment-analysis, and monitoring purposes?
  - a. Are multiple workout programs with different performance characteristics tracked separately?
  - b. Is the allowance allocation for each workout program equal to the estimated loss in each program, based on historical experience adjusted for current conditions and trends?
10. Is the total amount credited to the ALLL as recoveries on a loan limited to the amount previously charged off against the ALLL, and are any amounts that are collected in excess of this limit recognized as income?
11. Do the bank's policies and procedures address the types of allowed exceptions to the FFIEC's Uniform Retail Credit Classification and Account Management Policy and also the circumstances permitting those exceptions?
  - a. Is the volume of accounts that are granted exceptions small and well controlled?
  - b. Is the performance of accounts that are granted exceptions closely monitored?
  - c. Does the bank use exceptions prudently? If not, has management been criticized and has appropriate supervisory corrective action been recommended?
- h. the bill of sale is properly completed and signed by an officer?
- i. separate general ledger control is maintained?

## DELINQUENT ACCOUNTS AND OPERATING REVIEW SYSTEM

1. Are collection policies established so that—
  - a. a delinquent notice is sent before a loan becomes 30 days past due?
  - b. collection effort is intensified when a loan becomes two payments past due?
  - c. records of collection efforts are maintained in the customer's file?
  - d. field or outside collectors are under the supervision of an officer and are required to submit progress reports?
  - e. all collections are acknowledged on multicopy prenumbered forms?
  - f. all documents that are held outside the regular files and that pertain to installment loans under collection are evidenced by a transmittal sheet and receipt?
  - g. delinquency lists are generated on a timely basis (indicate the frequency)?
2. Is an operating review system in place that—
  - a. determines that duties are properly segregated and that loan officers are prohibited from processing loan payments?
  - b. recomputes the amount of credit life and accident and health insurance on new loans?
  - c. recomputes the amount of discount on new loans?
  - d. recomputes the rebates on prepaid loans?
  - e. test-checks daily transactions to subsequent general ledger postings?
  - f. reviews new-loan documentation?
  - g. reviews all information in reports being submitted to the board of directors, or any committee thereof, for errors or omissions?
  - h. conducts a periodic review of income accruals for accuracy?
  - i. reviews entries to unearned discount or income accounts?
  - j. reviews all charged-off loans for proper approval?
  - k. periodically reconciles charged-off notes to controls?

## REPOSSESSIONS

1. Are procedures established on repossessions so that—
  - a. management takes timely action to receive full advantage of any dealer endorsement or repurchase agreement?
  - b. the notice of intention to sell is mailed to all parties who are liable on the account?
  - c. bids are required before the sale of the item?
  - d. bids are retained in the borrower's credit file?
  - e. open repossessions are physically checked monthly?
  - f. surplus funds received from the sale of a repossession are mailed back to the borrower in the form of a cashier's check?
  - g. any deficiency balance remaining after the sale of repossession is charged off?

- l. reviews dealer's reserve and holdback agreements and periodically determines the adequacy of the balances in the deposit account?
- m. periodically verifies dealer reserve balances?
- n. determines that payments are accurately and promptly posted?
- o. reviews collection or reversal of late charges?
- p. determines that extension fees are collected on all extended loans?
- q. determines that discounted dealer paper is properly endorsed?
- r. determines that discounted dealer paper is within established guidelines?
- s. reviews compliance with laws and regulations?
- t. reviews trial balance reconcilements to the general ledger?

## CONCLUSION

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

Federally insured banks tend to avoid lending to customers with poor credit histories because of the higher risk of default and resulting loan losses. However, some lenders<sup>1</sup> extend their risk-selection standards to attract lower-credit-quality accounts.

Subprime lending involves extending credit to borrowers who exhibit characteristics that indicate a significantly higher risk of default than traditional bank lending customers.<sup>2</sup> The risk of default may be measured by traditional credit-risk measures (such as credit or repayment history or debt-to-income levels) or by alternative measures such as credit scores.

Subprime borrowers represent a broad spectrum of debtors, ranging from those who have repayment problems because of an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems, such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Generally, subprime borrowers will display a range of one or more credit-risk characteristics, such as—

- two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- bankruptcy in the last five years;
- relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product or collateral), or other bureau or proprietary scores with an equivalent default-probability likelihood; or
- debt-service-to-income ratio of 50 percent or greater, or an otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

1. The terms *lenders*, *financial institutions*, and *institutions* refer to federally insured banks and their subsidiaries.

2. For purposes of this section, loans to customers who are not subprime borrowers are referred to as *prime*.

Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase.

### SUPERVISORY GUIDANCE FOR SUBPRIME LENDING

The subprime supervisory guidance applies to direct extensions of credit; the purchase of subprime loans from other lenders, including delinquent or credit-impaired loans purchased at a discount; the purchase of subprime automobile or other financing “paper” from lenders or dealers; and the purchase of loan companies that originate subprime loans.

Subprime lending does not include loans to borrowers who have had minor, temporary credit difficulties but are now current. Also, the subprime-lending guidance does not generally apply to prime loans that develop credit problems after acquisition; loans that were initially extended in subprime programs and are later upgraded, as a result of their performance, to programs targeted to prime borrowers; and community development loans, as defined in the Community Reinvestment Act (CRA) regulations, that may have some higher risk characteristics, but are otherwise mitigated by guarantees from government programs, private credit enhancements, or other appropriate risk-mitigation techniques.

Subprime lending poses unique and significant risks to banking institutions engaged in the activity. Market events have raised supervisory issues about how well subprime lenders are prepared to manage and control the risks. Subprime-lending institutions need strong risk-management practices and internal controls, as well as board-approved policies and procedures that appropriately identify, measure, monitor, and control all associated risks. Institutions considering or engaging in this type of lending should recognize the additional risks inherent in this activity and determine if these risks are acceptable and controllable, given their organization’s financial condition, asset size, level of capital support, and staff size. Well-managed subprime lenders should recognize the heightened loss characteristics in their portfolios and internally classify their delinquent accounts well

before the time frames in their respective interagency supervisory policy.

Interagency guidance on subprime lending was issued on March 1, 1999, to alert examiners and financial institutions to some of the pitfalls and hazards involved in this type of lending.<sup>3</sup> (See SR-99-06.) Additional interagency examination guidance was issued on January 31, 2001, to further strengthen the supervision of certain institutions, primarily those institutions having subprime-lending programs with an aggregate credit exposure equaling or exceeding 25 percent of their tier 1 capital.<sup>4</sup> (See SR-01-04.) The aggregate exposure includes principal outstanding and committed, accrued and unpaid interest, and any retained residual interests<sup>5</sup> relating to securitized subprime loans. The Federal Reserve may also apply the additional guidelines to certain smaller subprime portfolios, such as those experiencing rapid growth or adverse performance trends, those administered by inexperienced management, and those with inadequate or weak controls.

Subprime loans command higher interest rates and loan fees than those offered to standard-risk borrowers. Subprime loans can be profitable, provided the price charged by the lender is sufficient to cover higher loan-loss rates and overhead costs related to underwriting, servicing, and collecting the loans. The ability to securitize and sell subprime portfolios at a profit while retaining the servicing rights makes subprime lending attractive to a larger number of institutions, further increasing the number of subprime lenders and loans. Some financial institutions have experienced losses attributable to ill-advised or poorly structured subprime-lending programs. These losses have attracted

greater supervisory attention to subprime lending and the ability of an insured bank to manage the unique risks associated with this activity.

## Risk Management

The following items are essential components of a well-structured risk-management program for subprime lenders.

### *Planning and Strategy*

Before engaging in subprime lending, the board and management should ensure that proposed activities are consistent with the institution's overall business strategy and risk tolerances, and that all involved parties have properly acknowledged and addressed critical business-risk issues. These issues include the costs associated with attracting and retaining qualified personnel, investments in the technology necessary to manage a more complex portfolio, a clear solicitation and origination strategy that allows for after-the-fact assessment of underwriting performance, and the establishment of appropriate feedback and control systems. The risk-assessment process should extend beyond credit risk and appropriately incorporate operating, compliance, and legal risks. Finally, the planning process should set clear objectives for performance, including the identification and segmentation of target markets or customers, as well as set performance expectations and benchmarks for each segment and the portfolio as a whole. Institutions establishing a subprime-lending program should proceed slowly and cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal-control problems and to determine if favorable initial profitability estimates are realistic and sustainable.

### *Staff Expertise*

Subprime lending requires specialized knowledge and skills that many financial institutions may not possess. Marketing, account-origination, and collections strategies and techniques often differ from those employed for prime credit; thus, it may not be sufficient to have the same lending staff responsible for both subprime loans and other loans. Additionally, servicing and

3. The March 1999 and January 2001 statements were adopted and issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

4. The March 1999 and January 2001 subprime-lending interagency guidance is consolidated within this section. To focus on the supervisory guidance that applies primarily to institutions having subprime-lending programs equaling or exceeding 25 percent of tier 1 capital, see the January 2001 release. The March 1999 interagency supervisory guidance applies to all subprime-lending institutions.

5. Residual interests are on-balance-sheet assets that represent interests (including beneficial interests) in transferred financial assets retained by a seller (or transferor) after a securitization or other transfer of financial assets. They are structured to absorb more than a pro rata share of credit loss related to the transferred assets through subordination provisions or other credit-enhancement techniques.

collecting subprime loans can be very labor intensive. If necessary, the institution should implement programs to train staff. The board should ensure that staff possess sufficient expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of subprime activity. The experience, or seasoning, of staff and loans should be taken into account as performance is assessed over time.

### *Lending Policy*

A subprime-lending policy should be appropriate to the size and complexity of the institution's operations and should clearly state the goals of the subprime-lending program. While not exhaustive, the following lending standards should be addressed in any subprime-lending policy:

- types of products offered as well as those that are not authorized
- portfolio targets and limits for each credit grade or class
- lending and investment authority clearly stated for individual officers, supervisors, and loan committees
- a framework for pricing decisions and profitability analysis that considers all costs associated with the loan, including origination costs, administrative or servicing costs, expected charge-offs, and capital
- evaluation of collateral and appraisal standards
- well-defined and specific underwriting parameters (that is, on acceptable loan term, debt-to-income ratios, and loan-to-collateral-value ratios for each credit grade and a minimum acceptable credit score) that are consistent with any applicable supervisory guidelines<sup>6</sup>
- procedures for the separate tracking and monitoring of loans approved as exceptions to stated policy guidelines
- credit-file documentation requirements, such as applications, offering sheets, loan and collateral documents, financial statements, credit

6. Extensions of credit secured by real estate, whether the credit is subprime or otherwise, are subject to the Interagency Guidelines for Real Estate Lending Policies, which establish supervisory loan-to-value (LTV) limits on various types of real estate loans and impose limits on an institution's aggregate investment in loans that exceed the supervisory LTV limits. (See 12 CFR 208, appendix C.)

reports, and credit memoranda to support the loan decision

- correspondent/broker/dealer approval process, including measures to ensure that loans originated through this process meet the institution's lending standards

If the institution elects to use credit scoring (including applications scoring) for approvals or pricing, the scoring model should be based on a development population that captures the behavioral and credit characteristics of the subprime population targeted for the products offered. Because of the significant variance in characteristics between the subprime and prime populations, institutions should not rely on models developed solely for products offered to prime borrowers. Further, the model should be reviewed frequently and updated as necessary to ensure that assumptions remain valid.

### *Purchase Evaluation*

As they evaluate expected profits, institutions that purchase subprime loans from other lenders or dealers must give due consideration to the cost of servicing these assets and to the loan losses that may be experienced. For instance, some lenders who sell subprime loans charge borrowers high up-front fees, which are usually financed into the loan. This provides incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation (that is, the quality of the loan may be less than the loan documents indicate).

Institutions should perform a thorough due-diligence review before committing to purchase subprime loans. Institutions should not accept loans from originators that do not meet their underwriting criteria, and they should regularly review loans offered to ensure that loans purchased continue to meet those criteria. Deterioration in the quality of purchased loans or in the portfolio's actual performance versus expectations requires a thorough reevaluation of the lenders or dealers who originated or sold the loans, as well as a reevaluation of the institution's criteria for underwriting loans and selecting dealers and lenders. Any such deterioration may also highlight the need to modify or termi-

nate the correspondent relationship or to adjust underwriting and dealer or lender selection criteria.

### *Loan-Administration Procedures*

After the loan is made or purchased, loan-administration procedures should provide for the diligent monitoring of loan performance and establish sound collection efforts. To minimize loan losses, successful subprime lenders have historically employed stronger collection efforts, such as calling delinquent borrowers frequently, investing in technology (for example, using automatic dialing for follow-up telephone calls on delinquent accounts), assigning more experienced collection personnel to seriously delinquent accounts, moving quickly to foreclose or repossess collateral, and allowing few loan extensions. This aspect of subprime lending is very labor intensive but critical to the program's success. To a large extent, the cost of such efforts can be a tradeoff with future loss expectations, when an institution analyzes the profitability of subprime lending and assesses its appetite to expand or continue this line of business. Subprime-loan administration procedures should be in writing and at a minimum should detail—

- billing and statement procedures;
- collection procedures;
- content, format, and frequency of management reports;
- asset-classification criteria;
- methodology to evaluate the adequacy of the allowance for loan and lease losses (ALLL);
- criteria for allowing loan extensions, deferrals, and re-agings;
- foreclosure and repossession policies and procedures; and
- loss-recognition policies and procedures.

### *Loan Review and Monitoring*

Once an institution books the loans, designated staff must perform an ongoing analysis of subprime loans, not only on an aggregate basis but also for subportfolios. Information systems should be in place to segment and stratify the institution's portfolio (for example, by originator, loan-to-value, debt-to-income ratios, or credit scores). Assigned staff should produce reports

that management can use to evaluate the performance of subprime loans. The review process should focus on whether performance meets expectations. Institutions then need to consider the source and characteristics of loans that do not meet expectations and make changes in their underwriting policies and loan-administration procedures to restore performance to acceptable levels.

When evaluating actual performance against expectations, it is particularly important that management review credit scoring, pricing, and any ALLL-adequacy models. Models driven by the volume and severity of historical losses experienced during an economic expansion may have little relevance in an economic slowdown, particularly in the subprime market. Management should ensure that models used to estimate credit losses or to set pricing allow for fluctuations in the economic cycle and are adjusted to account for other unexpected events.

### *Consumer Protection*

Institutions that originate or purchase subprime loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory “steering” of borrowers to subprime products for reasons other than the borrower's underlying creditworthiness. An adequate compliance-management program must identify, monitor, and control the consumer protection hazards associated with subprime lending.

Subprime mortgage lending may trigger the special protections of the Home Ownership and Equity Protection Act of 1994, subtitle B of title I of the Riegle Community Development and Regulatory Improvement Act of 1994. This act amended the Truth in Lending Act to provide certain consumer protections in transactions involving a class of nonpurchase, closed-end home mortgage loans. Institutions engaging in this type of lending must also be thoroughly familiar with the obligations set forth in Regulation Z (12 CFR 226.32), Regulation X (24 CFR 3500), and the Real Estate Settlement Procedures Act (RESPA) (12 USC 2601) and should adopt policies and implement practices that ensure compliance.

The Equal Credit Opportunity Act makes it unlawful for a creditor to discriminate against an

applicant on a prohibited basis regarding any aspect of a credit transaction. Similarly, the Fair Housing Act prohibits discrimination in connection with residential real estate–related transactions. Loan officers and brokers must treat all similarly situated applicants equally and without regard to any prohibited-basis characteristic (for example, race, sex, or age). This is especially important with respect to how loan officers or brokers assist customers in preparing their applications or otherwise help them to qualify for loan approval.

### *Securitization and Sale*

To increase their loan-production and -servicing income, some subprime lenders originate loans and then securitize and sell them in the asset-backed securities market. Strong demand from investors and favorable accounting rules often allow securitization pools to be sold at a gain, providing further incentive for lenders to expand their subprime-lending program. However, the securitization of subprime loans carries inherent risks, including interim credit risk and liquidity risks, which are potentially greater than those for securitizing prime loans. Accounting for the sale of subprime pools requires assumptions that can be difficult to quantify, and erroneous assumptions could lead to the significant overstatement of an institution's assets. Moreover, the practice of providing support and substituting performing loans for nonperforming loans to maintain the desired level of performance on securitized pools has the effect of masking credit-quality problems.

Institutions should recognize the volatility of the secondary market for subprime loans and the significant liquidity risk incurred when originating a large volume of loans intended for securitization and sale. Investors can quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. As a result, institutions that have originated, but have not yet sold, pools of subprime loans may be forced to sell the pools at deep discounts. If an institution lacks adequate personnel, risk-management procedures, or capital support to hold subprime loans that were originally intended for sale, these loans may strain an institution's liquidity, asset quality, earnings, and capital. Consequently, institutions actively involved in the securitization and sale of subprime loans should develop a contingency plan that addresses

backup purchasers of the securities or the attendant servicing functions, alternate funding sources, and measures for raising additional capital.

Institutions should refer to the Statement of Financial Accounting Standards No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," for guidance on accounting for these transactions. If a securitization transaction meets FAS 140 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights or obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations. In particular, management should consider the appropriate discount rates, credit-loss rates, and prepayment rates associated with subprime pools when valuing these assets. Since the relative importance of each assumption varies with the underlying characteristics of the product types, management should segment securitized assets by specific pool, as well as by predominant risk and cash-flow characteristics, when making the underlying valuation assumptions. In all cases, however, institutions should take a conservative approach when developing securitization assumptions and capitalizing expected future income from subprime-lending pools. Institutions should also consult with their auditors as necessary to ensure that their accounting for securitizations is accurate.

### *Reevaluation*

Institutions should periodically evaluate whether the subprime-lending program has met profitability, risk, and performance goals. Whenever the program falls short of original objectives, an analysis should be performed to determine the cause, and the program should be modified appropriately. If the program falls far short of the institution's expectations, management should consider terminating it. Questions that management and the board need to ask may include the following:

- Have cost and profit projections been met?
- Have projected loss estimates been accurate?



- Has the institution been called upon to provide support to enhance the quality and performance of loan pools it has securitized?
- Were the risks inherent in subprime lending properly identified, measured, monitored, and controlled?
- Has the program met the credit needs of the community that it was designed to address?

## Examination Review and Analysis

The following supervisory guidance (up to the examination objectives) applies only to banks that have subprime-lending programs equaling or exceeding 25 percent of tier 1 capital and to banks that have other designated subprime programs referenced in SR-01-4.

The heightened risk levels and potential volatility in delinquency and loss rates posed by subprime-lending programs warrant examiners' increased ongoing attention. The risks inherent in subprime-lending programs call for frequent reviews. There are generally two levels of review appropriate for subprime activities:

- *Portfolio-level reviews* include assessments of underwriting standards, marketing practices, pricing, management information and control systems (quality control, audit and loan review, vendor management, compliance), portfolio performance, and the appropriate application of regulatory and internal allowance and capital policies.
- *Transaction-level testing* includes the testing of individual loans for compliance with underwriting and loan-administration guidelines; the appropriate treatment of loans under delinquency, re-aging, and cure programs; and the appropriate application of regulatory and internal allowance and capital policies.

During each regularly scheduled examination cycle, examiners should perform a portfolio-level review and some transaction testing at each institution engaged in subprime lending. The Federal Reserve will perform regular off-site supervisory monitoring and may require subprime lenders to supply supplementary information about their subprime portfolios between examinations. The examiner's findings from transaction-level testing and portfolio-level reviews should be incorporated into the conclusions about overall asset quality, the adequacy

of the ALLL and capital, and the adequacy of portfolio risk-management practices.

### *Transaction-Level Testing*

Subprime-loan portfolios contain elevated risks, and actual subprime-lending practices often can deviate from stated policy and procedural guidance. Therefore, examiners should supplement the portfolio-level examination procedures with transaction-level testing to determine whether—

- individual loans adhere to existing policy, underwriting, risk-selection, and pricing standards;
- individual loans and portfolios are classified in accordance with the subprime-lending guidelines described in this section, or in other Federal Reserve credit-extending supervisory guidance;
- management, board, and regulatory reporting is accurate and timely;
- existing loans conform to specified account-management standards (such as over-limits, line increases, reductions, cancellations, re-scoring, or collections);
- key risk controls and control processes are adequate and functioning as intended;
- roll rates and other loss-forecasting methods used to determine ALLL levels are accurate and reliable; and
- lending practices exist that may appear unsafe, unsound, or abusive and unfair.

## Adequacy of the ALLL

Examiners should assess the adequacy of the ALLL to ensure that the portion allocated to the subprime portfolio is sufficient to absorb estimated credit losses for this portfolio. Consistent with interagency policy,<sup>7</sup> the term *estimated credit losses* means an estimate of the amount that is not likely to be collected; that is, net charge-offs that are likely to be realized given the facts and circumstances as of the evaluation date.<sup>8</sup> These estimated losses should meet the

7. The 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses was issued December 13, 2006. (See SR-06-17.) The Supplemental Interagency policy statement on the ALLL methodologies and documentation was issued July 2, 2001. (See SR-01-07.)

8. Estimates of credit losses should include accrued interest and other accrued fees (for example, uncollected credit card

criteria for accrual of loss contingency, as set forth under generally accepted accounting principles (GAAP), consistent with supervisory ALLL policy.

### *New Entrants to the Business*

In some instances, an institution (for example, a newly chartered institution or an existing institution entering the subprime-lending business) may not have sufficient previous loss experience to estimate an allowance for subprime-lending activities. In such cases, industry statistics or another institution's loss data for similar loans may be a better starting point to determine the ALLL than the institution's own data for developing loss rates. When an institution uses loss rates developed from industry statistics or from other institutions to determine its ALLL, it should demonstrate and document that the attributes of the loans in its portfolio or portfolio segment are similar to those in the other institution's (or industry's) portfolio.

### *Pools of Subprime Loans—Not Classified*

The ALLL required for subprime loans should be sufficient to absorb at least all estimated credit losses on outstanding balances over the current operating cycle, typically 12 months. The board of directors and management are expected to ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive and adequately documented analysis of all significant factors. The consideration factors should include historical loss experience, ratio analysis, peer-group analysis, and other quantitative analysis as a basis for the reasonableness of the ALLL. To the extent that the historical net charge-off rate is used to estimate expected credit losses, it should be adjusted for changes in trends, conditions, and other relevant factors, including business

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fees or uncollected late fees) that have been added to the loan balances and, as a result, are reported as part of the institution's loans on the balance sheet. An institution may include these types of estimated losses in either the ALLL or a separate valuation allowance, which would be netted against the aggregated loan balance for regulatory reporting purposes. When accrued interest and other accrued fees are not added to the loan balances and are not reported as part of loans on the balance sheet, the collectibility of these accrued amounts should nevertheless be evaluated to ensure that the institution's income is not overstated.

volume, underwriting, risk selection, account-management practices, and current economic or business conditions that may alter such experience. The allowance should represent a prudent, conservative estimate of losses that allows a reasonable margin for imprecision. Institutions should clearly document loss estimates and the allowance methodology in writing. This documentation should describe the analytical process used, including—

- portfolio-segmentation methods applied;
- loss-forecasting techniques and assumptions employed;
- definitions of terms used in ratios and model computations;
- relevance of the baseline loss information used;
- rationale for adjustments to historical experience; and
- a reconciliation of forecasted loss rates to actual loss rates, with significant variances explained.

### **Classification Guidelines for Subprime Lending**

Well-managed subprime lenders should recognize the heightened loss characteristics in their portfolios and internally classify their delinquent accounts well before the time frames outlined in the retail classification policy issued by the Federal Financial Institutions Examination Council (FFIEC) on June 12, 2000. Examiners should classify subprime loans and portfolios in accordance with the guidelines in this section and other applicable Federal Reserve supervisory guidelines. Classified loans are loans that are not protected adequately by the current sound worth and paying capacity of the borrower or the collateral pledged. As such, full liquidation of the debt may be in jeopardy. Pools of classified subprime loans (to include, at a minimum, all loans past due 90 days or more) should be reviewed for impairment, and an adequate allowance should be established consistent with existing interagency policy.

### *Individual Loans*

Examiners should not automatically classify or place loans in special mention merely because they are subprime. Rather, classifications should

reflect the borrower's capacity and willingness to repay and the adequacy of collateral pledged.

Loans to borrowers that do not have the capacity to service their loans generally will be classified substandard. When repayment capacity is insufficient to support the orderly liquidation of the debt, and the collateral pledged is insufficient to mitigate risk of loss, then a more severe classification and nonaccrual is warranted. Subprime loans that are past due 90 days or more should be classified at least substandard based on a reasonable presumption that their past-due status indicates an inadequate capacity or unwillingness to repay. A more stringent classification approach may be appropriate based on the historical loss experience of a particular institution. Classification of other subprime loans as doubtful or loss will be based on examiners' analysis of the borrower's capacity to repay, and on the quality of institution underwriting and account-management practices as evidenced in the loan file or by other documentation.

In some cases, the repayment of principal, interest, and fees on some subprime loans may be overly dependent on collateral pledged. This occurs when the risk of default is so high that an abundance of collateral is taken to mitigate risk of loss in the event of default. From a safety-and-soundness perspective, institutions should be discouraged from lending solely on the basis of collateral pledged. Such loans will generally be classified substandard. Further, when the borrower does not demonstrate the capacity to service the loan from sources other than collateral pledged, the loan may be placed on nonaccrual.

### Portfolios

When the portfolio review or loan sample indicates serious concerns with credit-risk selection practices, underwriting standards, or loan quality, examiners should consider classifying or criticizing the entire portfolio or segments of the portfolio. Such a decision may be appropriate in cases where risk is inordinately high or delinquency reports reflect performance problems. Some subprime-lending portfolios may pose very high risk. These may include portfolios of unsecured loans or secured, high loan-to-value loans to borrowers who clearly exhibit inadequate capacity to repay the debt in a reasonable time frame. Most such portfolios should be classified at least substandard.

### Required Documentation for Cure Programs

Cure programs, including such practices as re-aging, extensions, renewals, rewrites, or other types of account restructuring, are subject to the standards outlined in the retail classification policy. In accordance with that policy, cure programs should be used *only* when the institution has substantiated the customer's renewed willingness and ability to repay. Examiners will expect institutions to maintain documentation supporting their analysis of the customer's renewed ability and willingness to repay the loan at the time it is extended, renewed, or deferred. When the institution cannot demonstrate both the willingness and ability of the customer to repay, the loan should not be renewed, extended, deferred, or rewritten, and the loan should be moved back to its pre-cure delinquency status. Documentation should include one or more of the following:

- a new verification of employment
- a recomputed debt-to-income ratio indicating sufficient improvement in the borrower's financial condition to support orderly repayment
- a refreshed credit score or updated bureau report
- a file memo evidencing discussion with the customer

When documentation of the customer's renewed willingness and ability to repay the loan is absent or deficient, management practices should be criticized.

### Predatory or Abusive Lending Practices

The term "subprime" is often misused to refer to certain predatory or abusive lending practices. Lending practices can be designed to responsibly provide service to customers and enhance credit access for borrowers with special credit needs. Subprime lending that is appropriately underwritten, priced, and administered can serve these goals.

Some forms of subprime lending may be abusive or predatory, however. Lending practices may be designed to transfer wealth from the borrower to the lender or loan originator without a commensurate exchange of value.

This is sometimes accomplished when the lender structures a loan to a borrower who has little or no ability to repay the loan from sources other than the collateral pledged. When default occurs, the lender forecloses or otherwise takes possession of the borrower's property (generally the borrower's home or automobile). In other cases, the lender may use the threat of foreclosure or repossession to induce duress on the borrower for payment. Typically, predatory lending involves at least one, and perhaps all three, of the following elements:

- making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation
- inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced (that is, "loan flipping")
- engaging in fraud or deception to conceal the true nature of the loan obligation or ancillary products from an unsuspecting or unsophisticated borrower

Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound. Such lending practices should be criticized in the examination report as imprudent. Further, examiners should refer any loans with the aforementioned characteristics to Federal Reserve consumer compliance/fair lending specialists for additional review.

## Capitalization

The Federal Reserve's minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles than those that exist in subprime-loan programs. Therefore, these requirements may not be sufficient to reflect the risks associated with subprime portfolios. Subprime-lending activities can present a greater-than-normal risk for financial institutions and the deposit insurance funds; therefore, the level of capital institutions need to support this activity should be commensurate with the additional risks incurred. Each subprime lender is responsible for quantifying the amount of capital needed to offset the additional risk in subprime-lending activities, and for *fully docu-*

*menting* the methodology and analysis supporting the amount specified.

The amount of additional capital necessary will vary according to the volume and type of subprime activities conducted and the adequacy of the institution's risk-management program. An institution's overall capital adequacy will be evaluated on a case-by-case basis through on-site examinations and off-site monitoring procedures, considering, among other factors, the institution's own documented analysis of the capital needed to support subprime lending. Institutions that are determined to have insufficient capital must correct the deficiency within a reasonable time frame or be subject to supervisory action. In light of the higher risks associated with this type of lending, higher minimum-capital requirements may be imposed on institutions engaging in subprime lending.

The sophistication of this analysis should be commensurate with the size, concentration level, and relative risk of the institution's subprime-lending activities and should consider the following elements:

- portfolio-growth rates
- trends in the level and volatility of expected losses
- the level of subprime-loan losses incurred over one or more economic downturns, if such data or analyses are available
- the impact of planned underwriting or marketing changes on the credit characteristics of the portfolio, including the relative levels of risk of default, loss in the event of default, and the level of classified assets
- any deterioration in the average credit quality over time due to adverse selection or retention
- the amount, quality, and liquidity of collateral securing the individual loans
- any asset, income, or funding-source concentrations
- the degree of concentration of subprime credits
- the extent to which current capitalization consists of residual assets or other potentially volatile components
- the degree of legal or reputation risk associated with the subprime business lines pursued
- the amount of capital necessary to support the institution's other risks and activities

Given the higher risk inherent in subprime-lending programs, examiners should reasonably expect, as a starting point, that an institution

would hold capital against such portfolios in an amount that is *one and one-half to three times greater* than what is appropriate for non-subprime assets of a similar type. Refinements should depend on the factors analyzed above, with particular emphasis on the trends in the level and volatility of loss rates, and on the amount, quality, and liquidity of collateral securing the loans. Institutions should have capital ratios that are well above the averages for their traditional peer groups or other similarly situated institutions that are not engaged in subprime lending.

Some subprime asset pools warrant increased supervisory scrutiny and monitoring, but not necessarily additional capital. For example, well-secured loans to borrowers who are slightly below what is considered prime quality may entail minimal additional risks compared with prime loans, and they may not require additional capital if adequate controls are in place to address the additional risks. On the other hand, institutions that underwrite higher-risk subprime pools, such as unsecured loans or high loan-to-value second mortgages, may need significantly higher levels of capital, perhaps as high as 100 percent of the loans outstanding, depending on the level and volatility of risk.

### Stress Testing

An institution's capital adequacy analysis should include stress testing as a tool for estimating unexpected losses in its subprime-lending pools. Institutions should project the performance of their subprime-loan pools under conservative stress-test scenarios, including an estimation of the portfolio's susceptibility to deteriorating economic, market, and business conditions. Portfolio stress testing should include "shock" testing of basic assumptions, such as delinquency rates, loss rates, and recovery rates on collateral. Stress tests should also consider other potentially adverse scenarios, such as changing attrition or prepayment rates; changing utilization rates for revolving products; changes in credit-score distribution; and changes in the capital-market demand for whole loans or asset-backed securities supported by subprime loans. These are representative examples; actual factors will vary by product, market segment, and the size and complexity of the portfolio relative to the institution's overall operations. Whether stress

tests are performed manually, or through automated modeling techniques, it is expected that—

- the process is clearly documented, rational, and easily understood by the institution's board and senior management;
- the inputs are reliable and relate directly to the subject portfolios (for example, baseline loss history or default probabilities should reflect each segment of the institution's portfolio and not just a blend of prime and subprime borrowers);
- assumptions are well documented and conservative; and
- any models are subject to a comprehensive validation process.

The results of the stress-test exercises should be a documented factor in the analysis and determination of capital adequacy for the subprime portfolios.

Institutions that engage in subprime-lending programs without adequate procedures to estimate and document the level of capital necessary to support their activities should be criticized. Where capital is deemed inadequate to support the risk in subprime-lending activities, examiners should consult with their Reserve Bank supervisory official to determine the appropriate course of action. Such actions may include requiring additional capital in accordance with the Federal Reserve's capital adequacy rules, or requiring the institution to submit an acceptable capital plan in accordance with safety-and-soundness guidelines.

### Subprime-Lending Examiner Responsibilities

Using the interagency guidance and any supplemental Federal Reserve guidelines, examiners should assess carefully management's ability to administer the higher risk in subprime portfolios. The examiner should judge management's ability to manage the risk involved in the subprime-lending program, in particular, the quality of the risk-management and control processes in place, and more importantly, the extent to which management is adhering to those processes. When examiners determine that risk-management practices are deficient, they should criticize management and initiate corrective action. Such actions may include formal or

informal enforcement actions or a plan to achieve adequate capitalization. When a primary supervisor determines that an institution's risk-management practices are materially deficient, the primary supervisor may instruct the institution to discontinue its subprime-lending programs.

## APPENDIX—QUESTIONS AND ANSWERS FOR EXAMINERS REGARDING THE EXPANDED GUIDANCE FOR SUBPRIME-LENDING PROGRAMS

To assist examiners who review subprime-lending activities, the following questions and answers were developed to provide additional guidance on the expanded interagency guidance that was issued on January 31, 2001.

### Applicability of the Guidance

*Question 1: Does the guidance apply to all institutions?*

No. The guidance will not affect the vast majority of insured institutions engaged in traditional consumer lending. The guidance applies to institutions that *systematically* target the subprime market through *programs* that employ tailored marketing, underwriting standards, and risk selection.

The guidance does not address traditional consumer lending that has historically been the mainstay of community banking. It does not apply to institutions extending credit to subprime borrowers as part of their standard community-lending process, or making loans to subprime borrowers as an occasional exception to a prime-lending program, even if the aggregate of these loans totals more than 25 percent of tier 1 capital. Such institutions continue to be subject to the normal supervisory process.

Institutions engaging in subprime-lending programs generally have knowingly and purposefully focused on the subprime-lending markets through planned business strategies, tailored products, and explicit borrower targeting. In instances where significant exposures to subprime borrowers are identified, examiners should consider the institution's marketing program, loan products, pricing, underwriting standards and

practices, and portfolio performance to determine if the institution has a program that warrants the supervision and safeguards outlined in the guidance.

*Question 2: Does the guidance apply when an institution offers a product that attracts a disproportionate number of subprime borrowers, but which the institution does not explicitly identify as subprime?*

A subprime program commonly features products specifically tailored to borrowers with weakened credit histories. Such products often differ substantially in pricing and terms from products offered to prime borrowers, and usually have separate and distinctly different underwriting standards. An institution offering a product that attracts a disproportionate number of borrowers with weakened credit histories likely has a subprime program whether or not the activity is called a subprime program. The guidance will apply to these programs when the resultant aggregate credit exposure is at least 25 percent of the institution's tier 1 capital.

Institutions with significant programs are expected to have the necessary risk-management and internal-control systems in place to properly identify, measure, monitor, and control the inherent risks in its subprime portfolio. Risk management and controls for these programs typically involve enhanced performance monitoring, intensive collection activities, and other loss-mitigation strategies. If an institution systematically targets the subprime market but does not segregate these loans from its prime portfolio, it is doubtful that the institution has the necessary risk-management and control systems in place to safely engage in the activity.

### Subprime Characteristics

*Question 3: Why does the Expanded Guidance for Subprime Lending Programs use a credit bureau risk score (FICO) of 660 as a cutoff point for subprime lending?*

The guidance does not use credit scores, or any other single risk factor, as a definitive cutoff point for subprime lending. The characteristics listed are not explicit, bright-line definitions. The range of credit characteristics used to describe subprime borrowers is intended to help

examiners identify lenders that are engaged in subprime-lending programs. These characteristics describe borrowers with varying, but significantly higher, probabilities of default than prime borrowers. The guidance states that “this list is illustrative rather than exhaustive and is not meant to define specific parameters for all borrowers.”

A credit bureau score of 660 (FICO) is used only as an example to illustrate a credit score that generally indicates a higher default probability. The guidance indicates the probability of default, as evidenced by the credit score, will vary by product and collateral. The subprime guidance lists *several* characteristics that denote a higher probability of default. Examiners are directed to use these characteristics as a starting point to expand their review of lending programs targeting subprime borrowers in accordance with risk-focused examination procedures. The severity of risk may vary significantly for the different characteristics listed, as well as for the type and quality of collateral. Examiners should take this into consideration when reviewing the portfolio and determining the adequacy of loan-loss reserves and capital.

The characteristics used in the guidance are well recognized in the investment and lending industries. A number of public debt rating agencies and financial institutions, including the government-sponsored enterprises (GSEs), use similar credit characteristics to differentiate risk among borrowers. Specific examples include the following:

- Fitch defines a subprime borrower as “...one with a credit profile worse than that of a prime A quality borrower, whose credit report would typically reveal no recent mortgage delinquencies and whose credit profile would yield a [FICO] credit score in the range above 680.” Fitch’s mortgage credit grade matrix lists the following credit-history elements for A-, the highest subprime grade: one 30-day delinquency in the last 12 months on a mortgage debt; one 30-day delinquency in the last 24 months on installment debt, or two 30-day delinquencies in the last 24 months on revolving debt; bankruptcy in past five years; charge-off or judgments exceeding \$500 in the past 24 months; and/or a debt-to-income ratio of 45 percent.<sup>1</sup>

1. Fitch IBCA, Duff & Phelps, “Rating U.S. Residential Subprime Mortgage Securities, March 16, 2001: 2.

- Standard & Poor’s subprime-mortgage underwriting guidelines define subprime A-characteristics as two or more 30-day delinquencies on mortgage and consumer credit, one 60-day delinquency on consumer credit, debt-to-income ratio of 45 percent, and no bankruptcy in the past five years. Standard & Poor’s also “...considers subprime borrowers to have a FICO credit score of 659 or below.”<sup>2</sup>
- Standard & Poor’s has classified nonprime B auto securitization pools as having occasional delinquencies and minor charge-offs on revolving debt, static pool net losses of 3.1 percent to 7.5 percent, and FICO credit scores ranging from 620–679.<sup>3</sup>
- Freddie Mac has used the FICO score of 660 or below to designate higher-risk borrowers requiring more comprehensive review. Freddie Mac views a score in the 620–660 range as an indication that the “borrower’s willingness to repay debt as agreed is uncertain.” FICO scores below 620 are placed in the “cautious-review category,” and Freddie Mac considers scores below 620 “as a strong indication that the borrower’s credit reputation is not acceptable...”<sup>4</sup>

## Capital Guidance

*Question 4: If an institution is engaged in subprime lending as described by the guidance, does the 1.5-to-3 times capital described in the guidance automatically apply?*

No. The expanded interagency guidance on subprime lending is flexible examination guidance; the capital range does not automatically apply because the guidance is not a capital rule or regulation. Rather, the guidance describes an expectation that subprime lenders hold sufficient loan-loss reserves and capital to offset the additional risks that may exist in subprime activities. The agencies expect institutions to have methodologies and analyses in place to support and document the level of reserves and capital needed

2. Standard & Poor’s, “U.S. Residential Subprime Mortgage Criteria,” Structured Finance, 1999: 12, 169.

3. Standard & Poor’s, “Auto Loan Criteria and Market Overview 1998,” Structured Finance Ratings Asset-Backed Securities, 6.

4. Freddie Mac, Single-Family Seller/Servicer Guide, chapter 37, section 37.6, “Using FICO Scores in Underwriting,” March 7, 2001.

for the additional risks assumed. The higher the risk, the more reserves and capital needed to support the activity. Institutions with lower-risk subprime portfolios may not need additional reserves and capital. In addition, examiners are reminded that subprime lending is only one element in the evaluation of the institution's overall capital adequacy. If the analysis shows that the institution has adequate capital for all its assets and activities, including subprime lending, there is no additional capital requirement arising from the guidance.

Examiners are instructed not to unilaterally require additional reserves and capital based on the guidance. Any determination made by an examiner that an institution's reserves or capital are deficient will be discussed with the institution's management and with each agency's appropriate supervisory office before a final decision is made.

*Question 5: Are the regulatory expectations for higher capital levels consistent with capital levels supporting subprime assets outside the insured banking industry?*

Yes. The regulatory expectations of higher capital maintenance are consistent with expectations in the capital markets. The 1.5-to-3-times-capital multiple is risk based, e.g., the level of additional capital varies by relative loan quality and is applied only to the subprime portfolio, not the institution's entire asset structure. This is consistent with the financial marketplace's assessment of relative risk in subprime assets outside the banking industry. For example, the amount of credit enhancement required for subprime securitization structures varies according to the level and volatility of perceived credit risk in the underlying assets. In addition, publicly traded subprime-finance companies (that are not currently suffering from adverse ratings) maintain equity-capital-to-managed-asset ratios that are 1.5 to as much as 6 times (depending on loan type and relative quality) those of finance companies that do not specialize in subprime loans.



# Subprime Lending

## Examination Objectives

Effective date November 2002

## Section 2133.2

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1. To assess and evaluate the extent of subprime-lending activities; whether management has adequately planned for this activity; and whether management has developed and maintains board-approved policies and procedures, systems, and internal controls that identify, measure, monitor, and control the additional risks.
2. To ascertain whether management has established adequate subprime-lending standards that are commensurate with the risks associated with the subprime-lending program.
3. To conduct portfolio-level reviews and transaction-level testing of the subprime-lending activities, assessing the quality and performance of the subprime-loan portfolios and subprime-lending program, including its profitability, delinquency, and potential and actual loss experience.
4. To assess the adequacy of the allowance for loan and lease losses (ALLL) for the subprime-loan portfolio.

# Subprime Lending Examination Procedures

Effective date November 2002

## Section 2133.3

1. Determine whether the subprime-lending activities are consistent with the bank's overall business strategy and risk tolerances, and that the critical business risks have been identified and considered.
2. Assess whether the bank has the financial capacity, including capital adequacy, to conduct the high-risk activity of subprime lending safely, without any undue concentrations of credit.
3. Ascertain if management has committed the necessary resources, that is, technology and skilled personnel, to manage and control the risks associated with the volume and complexity of the subprime-lending program.
4. Determine whether the banking institution's contingency plans are adequate to address the issues of (1) alternative funding sources, (2) back-up purchasers of the securities or the attendant servicing functions, and (3) methods of raising additional capital during an economic downturn or when financial markets become volatile.
5. Determine if management has established adequate lending standards that are appropriate for the size and complexity of the banking organization's operations, and if management is maintaining proper controls over the program. (See "Risk Management" in section 2133.1 for the lending standards that should be included in the subprime-loan program.)
6. Review and evaluate loan-administration and loan-monitoring procedures for subprime loans originated or purchased, including—
  - a. collection, repossession, and disclosure procedures;
  - b. the management of the number of staff members, the level and effective use of skilled staffing, and advanced technology;
  - c. the adequacy of the allowance for loan and lease losses (ALLL); and
  - d. the adequacy and accuracy of models used to estimate credit losses or set pricing, making certain that the models account for economic cycles and other unexpected events.
7. Perform a portfolio-level review and conduct some transaction testing. Incorporate examination findings from the portfolio-level and transaction-level testing reviews into the conclusions about overall asset quality, the adequacy of the ALLL and capital, and the adequacy of portfolio risk-management practices.
8. Review securitization transactions for compliance with Statement of Financial Accounting Standards No. 140 (FAS 140) and this guidance, including whether the banking organization has provided any support to maintain the credit quality of loan pools it has securitized.
9. Evaluate the ALLL and regulatory capital allocated to support subprime-lending programs, including whether the total protection for subprime-asset programs and the levels for each component are adequate. Ascertain that a sound risk-management program exists that includes the ability of management to determine and quantify appropriate levels for each component.
10. Analyze the performance of the program, including its profitability, delinquency, and loss experience.
11. Consider management's response to adverse performance trends, such as higher-than-expected prepayments, delinquencies, charge-offs, customer complaints, and expenses.
12. Determine if the banking institution's subprime-lending program effectively manages the credit, market, liquidity, reputational, operational, and legal risks associated with subprime-lending operations.
13. Evaluate the documented analysis of the institution's capital needed to support its subprime-lending activities. Ascertain whether the capital levels are risk sensitive, that is, does allocated capital reflect the level and variability of loss estimates within reasonably conservative parameters? Determine if there is a direct link between the expected loss rates used to determine the required ALLL and the unexpected loss estimates used to determine capital. Document and reference each institution's subprime capital evaluation in the examination comments and conclusions regarding capital adequacy.
14. Classify loans according to the following criteria:

- a. Classify as substandard loans to borrowers that do not have the capacity to service their loans.
  - b. Classify as at least substandard subprime loans that are 90 days or more past due based on a reasonable presumption that their past-due status indicates an inadequate capacity or unwillingness to repay.
  - c. Consider classifying or criticizing the entire portfolio or segments of the portfolio when the portfolio review or loan sample indicates serious concerns with credit-risk selection practices, underwriting standards, or loan quality.
  - d. Classify as substandard high-risk unsecured loan portfolios or secured high loan-to-value loans to borrowers who clearly exhibit inadequate capacity to repay the debt in a reasonable time frame.
15. Report as unsafe and unsound imprudent loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the pledged collateral. Refer such loans to a consumer compliance/fair lending specialist for review.
  16. Carefully assess management's ability to administer the higher risk in subprime portfolios. If risk-management practices are deficient, criticize management and reach specific agreements with senior management and the board of directors to initiate corrective action.

# Subprime Mortgage Lending

Effective date October 2007

## Section 2135.1

An interagency Statement on Subprime Mortgage Lending (the subprime statement) was issued on July 10, 2007 (72 Fed. Reg. 37569) by the agencies<sup>1</sup> (same effective date). The subprime statement address issues and questions related to certain adjustable-rate mortgage (ARM) products marketed to subprime borrowers. The statement clarifies how institutions can offer certain ARM products in a safe and sound manner, and in a way that clearly discloses the risks that a borrower may assume from certain ARMs. The statement applies to all banks and their subsidiaries and bank holding companies and their nonbank subsidiaries. See SR-07-12/CA-07-3 and its attachment (the full text of the interagency statement).

The guidance was developed to address emerging risks associated with certain subprime mortgage products and lending practices. The agencies are particularly concerned about the growing use of ARM products<sup>2</sup> that provide low initial payments based on a fixed introductory rate that expires after a short period, and then adjusts to a variable rate plus a margin for the remaining term of the loan. These products could result in payment shock to the borrower. Also, there is concern that these products, typically offered to subprime borrowers, present heightened risks to lenders and borrowers. Often, these products have additional characteristics that increase risk. These include qualifying borrowers based on limited or no documentation of income or imposing substantial prepayment penalties or prepayment penalty periods that extend beyond the initial fixed-interest-rate period.

ARM products originally were extended to customers primarily as a temporary credit accommodation in anticipation of early sale of the property or in expectation of future earnings growth. However, these loans have been offered to subprime borrowers as “credit repair” or “affordability” products. The agencies had concerns that many of these subprime borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment. Also, there was concern that the

subprime borrowers may not fully understand the risks and consequences of obtaining these types of ARM products. Borrowers who obtain these loans may face unaffordable monthly payments after the initial rate adjustment, difficulty in paying real estate taxes and insurance that were not escrowed, or expensive refinancing fees, any of which could cause borrowers to default and potentially lose their homes.

### SCOPE OF THE SUBPRIME STATEMENT

The subprime statement emphasizes the need for prudent underwriting standards and clear and balanced consumer information so that institutions and consumers can assess the risks arising from certain ARM products with discounted or low introductory rates. The statement is focused on these types of ARMs and uses the interagency Expanded Guidance for Subprime Lending (the expanded guidance)<sup>3</sup> issued in 2001 to determine subprime borrower characteristics. While the statement is focused on subprime borrowers, the principles in the statement are also relevant to ARM products offered to non-subprime borrowers.

### RISK-MANAGEMENT PRACTICES

The risk-management practices discussed in the subprime statement are generally consistent with existing interagency guidance regarding real estate lending, subprime lending, and nontraditional mortgage products.<sup>4</sup> Like the nontradi-

1. The Board of Governors of the Federal Reserve System (the Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA).

2. See footnote 8.

3. As discussed in the 2001 interagency Expanded Guidance for Subprime Lending Programs, the term “subprime” refers to the characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems, such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

4. The 1993 Interagency Guidelines for Real Estate Lending (see SR-93-1 and sections 2090.1–2090.4); the 1999 Interagency Guidance on Subprime Lending (see SR-99-6 and sections 2133.1–2133.3); the 2001 Expanded Guidance for Subprime Lending Programs (see SR-01-4 and sections 2133.1–2133.3); and the 2006 Interagency Guidance on Non-traditional Mortgage Product Risks (see SR-06-15/CA-06-12 and sections 2043.1–2043.4).

tional mortgage guidance issued in 2006, the subprime statement encourages institutions to evaluate the borrower's repayment capacity and ability to repay the loan by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule.<sup>5</sup> Further, the subprime statement emphasizes that an institution's assessment of a borrower's repayment capacity should include an evaluation of the borrower's debt-to-income ratio and states that this assessment should include total monthly housing-related payments (i.e., principal, interest, taxes, and insurance).

## WORKOUT ARRANGEMENTS

The subprime statement reiterates the principles in the interagency Statement on Working with Borrowers (April 2007) in which the agencies encouraged institutions to work constructively with residential borrowers who are in default or whose default is reasonably foreseeable. Both documents indicate that prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower. The Federal Reserve will not criticize institutions that pursue reasonable workout arrangements with borrowers.

## SUPERVISORY REVIEW

Federal Reserve examiners are expected to carefully review an institution's risk management, consumer-disclosure practices, and consumer compliance, concerns which are contained in the subprime statement as a part of ongoing examination activities. Examiners will take action against institutions that exhibit predatory lending practices, violate consumer protection or fair lending laws, engage in unfair or deceptive acts or practices, or otherwise engage in unsafe or unsound lending practices.

5. The nontraditional mortgage (NTM) guidance covers mortgage products that allow borrowers to defer payment of principal and sometimes interest, including interest-only mortgages when a borrower pays no loan principal for the first few years of the loan and payment-option ARMs when a borrower has flexible payment options with the potential for negative amortization. Because certain ARM products offered to subprime borrowers are fully amortizing, the NTM guidance does not cover such products.

## STATEMENT ON SUBPRIME MORTGAGE LENDING

The Statement on Subprime Mortgage Lending (the subprime statement) was developed by the agencies to address emerging issues and questions relating to certain subprime<sup>6</sup> mortgage lending practices. The agencies stated their concern that borrowers may not fully understand the risks and consequences of obtaining products that can cause payment shock.<sup>7</sup> In particular, they have concerns with certain adjustable-rate mortgage (ARM) products typically offered to subprime borrowers that have one or more of the following characteristics:

- low initial payments based on a fixed introductory rate that expires after a short period and then adjusts to a variable index rate plus a margin for the remaining term of the loan;<sup>8</sup>
- very high or no limits on how much the payment amount or the interest rate may increase ("payment or rate caps") on reset dates;
- limited or no documentation of borrowers' income;
- product features likely to result in frequent refinancing to maintain an affordable monthly payment; and/or
- substantial prepayment penalties and/or prepayment penalties that extend beyond the initial fixed-interest-rate period.

Products with one or more of these features present substantial risks to both consumers and lenders. These risks are increased if borrowers are not adequately informed of the product features and risks, including their responsibility for paying real estate taxes and insurance, which may be separate from their monthly mortgage payments. The consequences to borrowers could

6. The term "subprime" is described in the 2001 Expanded Guidance for Subprime Lending Programs. (See SR-01-4 and sections 2133.1–2133.3)

7. *Payment shock* refers to a significant increase in the amount of the monthly payment that generally occurs as the interest rate adjusts to a fully indexed basis. Products with a wide spread between the initial interest rate and the fully indexed rate that do not have payment caps or periodic interest rate caps, or that contain very high caps, can produce significant payment shock.

8. For example, ARMs known as "2/28" loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed interest rate and the fully indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.

include being unable to afford the monthly payments after the initial rate adjustment because of payment shock; experiencing difficulty in paying real estate taxes and insurance that were not escrowed; incurring expensive refinancing fees, frequently due to closing costs and prepayment penalties, especially if the prepayment penalty period extends beyond the rate adjustment date; and losing their homes. Consequences to lenders may include unwarranted levels of credit, legal, compliance, reputation, and liquidity risks due to the elevated risks inherent in these products.

Many of these concerns are addressed in existing interagency guidance. The most prominent are the 1993 Interagency Guidelines for Real Estate Lending (real estate guidelines) (see SR-93-1 and sections 2090.1–2090.4), the 1999 Interagency Guidance on Subprime Lending (see SR-99-6 and sections 2133.1–2133.3) and the 2001 Expanded Guidance for Subprime Lending Programs (expanded subprime guidance) (see SR-01-4 and sections 2133.1–2133.3).

While the 2006 Interagency Guidance on Nontraditional Mortgage Product Risks (NTM guidance)<sup>9</sup> may not explicitly pertain to products with the characteristics addressed in this statement, it outlines prudent underwriting and consumer protection principles that institutions also should consider with regard to subprime mortgage lending. This statement reiterates many of the principles addressed in existing guidance relating to prudent risk-management practices and consumer protection laws.<sup>10</sup>

## Risk-Management Practices

### *Predatory Lending Considerations*

Subprime lending is not synonymous with predatory lending, and loans with the features described above are not necessarily predatory in nature. However, institutions should ensure that they do not engage in the types of predatory lending practices discussed in the expanded subprime guidance. Typically, predatory lending involves at least one of the following elements:

- making loans based predominantly on the foreclosure or liquidation value of a borrower's collateral rather than on the borrower's ability to repay the mortgage according to its terms;
- inducing a borrower to repeatedly refinance a loan in order to charge high points and fees each time the loan is refinanced (“loan flipping”); or
- engaging in fraud or deception to conceal the true nature of the mortgage loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

Institutions offering mortgage loans such as these face an elevated risk that their conduct will violate section 5 of the Federal Trade Commission Act (FTC Act), which prohibits unfair or deceptive acts or practices.<sup>11</sup>

### *Underwriting Standards*

Institutions should refer to the real estate guidelines, which provide underwriting standards for all real estate loans.<sup>12</sup> The real estate guidelines state that prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt. The 2006 NTM guidance details similar criteria for qualifying borrowers for products that may result in payment shock.

Prudent qualifying standards recognize the potential effect of payment shock in evaluating a borrower's ability to service debt. An institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate,<sup>13</sup> assuming a fully

9. See SR-06-1, sections 2043.1–2043.4, and 71 *Fed. Reg.* 58609 (October 4, 2006).

10. As with the NTM guidance, this statement applies to all banks and their subsidiaries as well as to bank holding companies and their nonbank subsidiaries.

11. The Board, the OCC, the OTS, and the FDIC enforce this provision under section 8 of the Federal Deposit Insurance Act. The Board, the OCC, and the FDIC also have issued supervisory guidance to the institutions under their respective jurisdictions concerning unfair or deceptive acts or practices. See OCC Advisory Letter 2002-3, Guidance on Unfair or Deceptive Acts or Practices, March 22, 2002, and 12 CFR 30, appendix C; Joint Board and FDIC Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks, March 11, 2004.

12. Refer to 12 CFR 208, subpart C.

13. The fully indexed rate equals the index rate prevailing at origination plus the margin to be added to it after the expiration of an introductory interest rate. For example, assume that a loan with an initial fixed rate of 7 percent will reset to the six-month London Interbank Offered Rate (LIBOR) plus a margin of 6 percent. If the six-month LIBOR rate

amortizing repayment schedule.<sup>14</sup>

One widely accepted approach in the mortgage industry is to quantify a borrower's repayment capacity by a debt-to-income (DTI) ratio. An institution's DTI analysis should include, among other things, an assessment of a borrower's total monthly housing-related payments (e.g., principal, interest, taxes, and insurance, or what is commonly known as PITI) as a percentage of gross monthly income.

This assessment is particularly important if the institution relies upon reduced documentation or allows other forms of risk layering. Risk-layering features in a subprime mortgage loan may significantly increase the risks to both the institution and the borrower. Therefore, an institution should have clear policies governing the use of risk-layering features, such as reduced-documentation loans or simultaneous second-lien mortgages. When risk-layering features are combined with a mortgage loan, an institution should demonstrate the existence of effective mitigating factors that support the underwriting decision and the borrower's repayment capacity.

Recognizing that loans to subprime borrowers present elevated credit risk, institutions should verify and document the borrower's income (both source and amount), assets, and liabilities. Stated-income and reduced-documentation loans to subprime borrowers should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. Reliance on such factors also should be documented. Typically, mitigating factors arise when a borrower with favorable payment performance seeks to refinance an existing mortgage with a new loan of a similar size and with similar terms, and the borrower's financial condition has not deteriorated. Other mitigating factors might include situations where a borrower has substantial liquid reserves or assets that demonstrate repayment capacity and can be verified and documented by the lender. However, a higher interest rate is not considered an acceptable mitigating factor.

equals 5.5 percent, lenders should qualify the borrower at 11.5 percent (5.5 percent + 6 percent), regardless of any interest rate caps that limit how quickly the fully indexed rate may be reached.

14. The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a "2/28" loan would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

## Workout Arrangements

As discussed in the April 2007 Interagency Statement on Working with Borrowers (see SR-07-6/CA-07-1), financial institutions are encouraged to work constructively with residential borrowers who are in default or whose default is reasonably foreseeable. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

Financial institutions should follow prudent underwriting practices in determining whether to consider a loan modification or a workout arrangement.<sup>15</sup> Such arrangements can vary widely based on the borrower's financial capacity. For example, an institution might consider modifying loan terms, including converting loans with variable rates into fixed-rate products to provide financially stressed borrowers with predictable payment requirements.

The agencies will not criticize financial institutions that pursue reasonable workout arrangements with borrowers. Further, existing supervisory guidance and applicable accounting standards do not require institutions to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties. Institutions should identify and report credit risk, maintain an adequate allowance for loan losses, and recognize credit losses in a timely manner.

## Consumer Protection Principles

Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include—

- approving loans based on the borrower's ability to repay the loan according to its terms; and
- providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select a product.

## Communications with consumers, including

15. Institutions may need to account for workout arrangements as troubled-debt restructurings and should follow generally accepted accounting principles in accounting for these transactions.

advertisements, oral statements, and promotional materials, should provide clear and balanced information about the relative benefits and risks of the products. This information should be provided in a timely manner to assist consumers in the product-selection process, not just upon submission of an application or at consummation of the loan. Institutions should not use such communications to steer consumers to these products to the exclusion of other products offered by the institution for which the consumer may qualify.

Information provided to consumers should clearly explain the risk of payment shock and the ramifications of prepayment penalties, balloon payments, and the lack of escrow for taxes and insurance, as necessary. The applicability of prepayment penalties should not exceed the initial reset period. In general, borrowers should be provided a reasonable period of time (typically at least 60 days prior to the reset date) to refinance without penalty.

Similarly, if borrowers do not understand that their monthly mortgage payments do not include taxes and insurance, and they have not budgeted for these essential homeownership expenses, they may be faced with the need for significant additional funds on short notice.<sup>16</sup> Therefore, mortgage-product descriptions and advertisements should provide clear, detailed information about the costs, terms, features, and risks of the loan to the borrower. Consumers should be informed of—

- *payment shock*: potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires;<sup>17</sup>
- *prepayment penalties*: the existence of any prepayment penalty, how it will be calculated, and when it may be imposed;

16. Institutions generally can address these concerns most directly by requiring borrowers to escrow funds for real estate taxes and insurance.

17. To illustrate: a borrower earning \$42,000 per year obtains a \$200,000 “2/28” mortgage loan. The loan’s two-year introductory fixed interest rate of 7 percent requires a principal and interest payment of \$1,331. Escrowing \$200 per month for taxes and insurance results in a total monthly payment of \$1,531 (\$1,331 + \$200), representing a 44 percent DTI ratio. A fully indexed interest rate of 11.5 percent (based on a six-month LIBOR index rate of 5.5 percent plus a 6 percent margin) would cause the borrower’s principal and interest payment to increase to \$1,956. The adjusted total monthly payment of \$2,156 (\$1,956 + \$200 for taxes and insurance) represents a 41 percent increase in the payment amount and results in a 62 percent DTI ratio.

- *balloon payments*: the existence of any balloon payment;
- *cost of reduced-documentation loans*: whether there is a pricing premium attached to a reduced-documentation or stated-income loan program; and
- *responsibility for taxes and insurance*: the requirement to make payments for real estate taxes and insurance in addition to their loan payments, if not escrowed, and the fact that taxes and insurance costs can be substantial.

## Control Systems

Institutions should develop strong control systems to monitor whether actual practices are consistent with their policies and procedures. Systems should address compliance and consumer information concerns, as well as safety and soundness, and encompass both institution personnel and applicable third parties, such as mortgage brokers or correspondents.

Important controls include establishing appropriate criteria for hiring and training loan personnel, entering into and maintaining relationships with third parties, and conducting initial and ongoing due diligence on third parties. Institutions also should design compensation programs that avoid providing incentives for originations inconsistent with sound underwriting and consumer protection principles, and that do not result in the steering of consumers to these products to the exclusion of other products for which the consumer may qualify.

Institutions should have procedures and systems in place to monitor compliance with applicable laws and regulations, third-party agreements, and internal policies. An institution’s controls also should include appropriate corrective actions in the event of failure to comply with applicable laws, regulations, third-party agreements, or internal policies. In addition, institutions should initiate procedures to review consumer complaints to identify potential compliance problems or other negative trends.

## Supervisory Review

The agencies will continue to carefully review risk-management and consumer compliance processes, policies, and procedures. The agen-



cies will take action against institutions that exhibit predatory lending practices, violate consumer protection laws or fair lending laws,

engage in unfair or deceptive acts or practices, or otherwise engage in unsafe or unsound lending practices.

### INTRODUCTION

Agricultural loans can be broadly defined as loans made to agricultural producers to finance the production of crops or livestock. The term “crops” is meant to include any of the many types of plants that produce grains, fruits, vegetables, or fibers that can be harvested. Similarly, a variety of animals is produced for profit, although cattle, swine, sheep, and poultry are by far the most common. Production cycles vary with the type of crop or livestock, from a few weeks or months to several years; in the case of an orchard crop or timber, the time from planting to harvest (from cash outlay to the generation of income) is quite lengthy. The type of crop or livestock to be produced will determine the nature of the financing needed, including its timing, collateral considerations, and repayment terms.

Repayment terms for farm loans normally correspond to anticipated cash flows. Since repayment of agricultural-related loans usually comes from the sale of crops or livestock, annual repayment terms are not uncommon. Depending on the type of operation and timing of cash income, payments may be set to come due semiannually, quarterly, or on an irregular schedule. However, many smaller farm operators also receive income from nonfarm employment, which allows them to make monthly payments on some loans.

Agricultural producers need access to land (often with buildings and other improvements) and equipment, in addition to the shorter-term operating inputs directly involved in crop or livestock production. Not all producers own land; some are tenants who pay the landowners cash rent or a portion of the crop yield. Many producers both own and rent or lease land in an effort to maximize efficiency and income. Accordingly, individual producers may need a variety of types of loans, including—

- real estate loans,
- equipment loans,
- livestock loans, and
- operating (or production) loans.

Information on each of these types of agricultural loans follows, as well as general comments on agricultural lending and the examiner’s review of agricultural loans.

### AGRICULTURAL REAL ESTATE LOANS

Real estate loans are not intended as a primary focus of this manual section. However, real estate loans are a significant portion of total debt for many agricultural producers, and the examiner should consider them when evaluating other types of loans to agricultural producers. For a more thorough discussion of real estate loans, refer to section 2090.1, “Real Estate Loans.” Loans to finance agricultural land, together with related improvements (frequently including the producer’s residence) comprise the most common type of real estate loan made by agricultural banks. These loans are subject to the same general lending principles and legal and regulatory requirements<sup>1</sup> as loans on other types of real estate. Even if a bank has not made a real estate loan to the agricultural borrower, any real estate debt owed elsewhere must be considered in analyzing the borrower’s creditworthiness, along with amounts due to the bank and any other creditors. Additionally, any state laws on homestead exemptions should be noted.

Agricultural real estate loans tend to have special characteristics, particularly with regard to valuation and repayment considerations. For instance, farmland appraisers need special knowledge of soil types, topography, data on rainfall or water tables, and crop production data, as well as a knowledge of area market conditions and other extenuating information. Prevailing market values for farmland tend not to permit as high a level of cash return as those for other types of income-producing property. Values always reflect supply and demand, and, probably due to a number of factors, the demand for farmland has traditionally been relatively strong from neighboring landowners, other area farmers, nonfarmers, and absentee owners who have a strong desire to own land. A lower level of return generally dictates a lower loan-to-value ratio, although a borrower may be able to

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1. In connection with the supervisory loan-to-value limits set forth in the “Interagency Guidelines for Real Estate Lending Policies,” farmland, ranchland, or timberland committed to ongoing management and agricultural production is considered “improved property,” subject to a loan-to-value limit of 85 percent. However, a bank may set a lower limit for itself and, as a matter of policy, probably will loan less than 85 percent of appraised value on farmland in most cases.

service debt at a higher level from other income sources such as less-heavily encumbered land, rented land, or nonfarm income. For example, it would not be unusual for a bank to advance 100 percent of the purchase price of land if a lien on additional land is taken to lower the overall loan-to-value ratio.

There is generally a well-established market for agricultural land. Although values fluctuate based on a variety of factors (just as they do with other types of real estate), there is normally a recognized range of values at any given time for particular land types within a general area. The examiner should gain some knowledge of current area land prices and trends through published data from local universities or private organizations, interviews with bank management, and the review of appraisal reports. This knowledge will be vital in assessing collateral values and the borrower's overall financial condition and future prospects.

An amortization period of up to 20 years is not uncommon for agricultural real estate loans by banks. Longer-term loans (up to 30 years) on farm real estate are sometimes made by commercial banks, but are more common with other lenders such as Federal Land Banks. Many banks structure real estate loans so that required payments are based on a 20- to 30-year amortization, but they write the notes with a 5- to 10-year maturity, at which time a balloon payment is due. Major improvements, such as livestock-confinement buildings or grain-handling facilities, commonly have a shorter amortization period of 10 years or less.

## AGRICULTURAL MACHINERY AND EQUIPMENT LOANS

Agricultural producers often need to finance the purchase of machinery, equipment, vehicles, and implements. Typically, these loans are secured by the durable goods being financed and are amortized over an intermediate term of up to seven years. As with any equipment loan, some borrower equity should be required, the amortization period should be no longer than the expected useful life of the equipment, and scheduled payments should correlate reasonably with the timing and amount of anticipated income. In some cases, equipment loan payments may be advanced under the borrower's operating line of credit.

Loans to farmers and ranchers may include individual notes to finance the purchase of specific pieces of equipment or vehicles. However, many agricultural borrowers provide the bank with a blanket lien on all equipment and vehicles to secure any and all debts owed the bank. Frequently, borrowers have both purchase money loans on specific equipment and other loans secured by a blanket equipment lien.

Under the Uniform Commercial Code, a security interest in equipment is created with a security agreement signed by the borrower and a bank officer, and the lien is perfected by a centrally filed financing statement. Many banks file the financing statement in both the county and state in which the borrower resides *and* in the county and state in which the equipment is located. The filing is a public record that notifies lenders or other interested parties that the assets identified have been pledged, as well as to whom and when they were pledged.

Since the filing record provides vital information for potential lenders, bank management must check it before extending credit to determine whether the collateral is already pledged to another lender. In many cases, a bank might approve a loan request only if it were to be in a first lien position, but there can be exceptions. For example, a bank may agree to advance on a second lien position in a large piece of equipment in which the borrower has substantial equity or take a blanket lien on all equipment, including one or a few items of equipment pledged elsewhere (such as a purchase money lien held by an equipment dealer). As a matter of prudent lending and sound loan administration, lien searches should be performed periodically on at least larger borrowers or on those borrowers known to be or suspected of having problems or of being involved with other lenders.

Sound bank lending policies should prescribe a maximum loan-to-value ratio for equipment, as well as maximum repayment terms. The same is true for vehicles, although the loan-to-value limits on vehicles for highway use (automobiles and trucks) tend to be higher because they have a less-specialized use and are more liquid. Maximum loan-to-value limits, particularly for loans to purchase specific pieces of farm equipment, may range to more than 80 percent or even to 100 percent for strong borrowers. However, many farm lines of credit are supported in part by blanket liens on all the borrower's

equipment. Typically, overall loan-to-value ratios on a line of equipment do not exceed 60 percent.

## LIVESTOCK LOANS

Livestock loans vary with the animal species and the nature of the individual producer's operation, but the same general lending principles apply to virtually all types of livestock loans. The borrower should have an equity position in the livestock financed, ample feed on hand, or another underlying financial strength that will protect the lender from risks such as losses from animal diseases and deaths, rising feed costs, or market fluctuations. The size of the livestock operation should be commensurate with the borrower's physical facilities and management capability. Total debt should not overburden the borrower, and the timing and source of repayment for loans should be understood when they are originated. The term of a livestock loan normally bears a close relationship to the length of time the animals are to be held.

Feed is a necessity for livestock producers and a major expense for those involved in finishing animals for slaughter, dairy herds, or egg-laying operations. On the other hand, stocker cattle feed mainly on pasture or silage, which reduces feed costs. Some livestock producers also raise feed crops, which may improve their overall efficiency. Many producers, however, need to buy feed. In any event, the loan officer should have a firm understanding of how much feed the borrower has on hand (or will be harvesting) and how much will have to be purchased. Still, even though both borrower and banker may be experienced and capable at projecting feed costs, variables beyond their control impose some risk of increased costs. These variables might include perils such as unfavorable weather or disease affecting feed crop yields or rising feed prices or shortages brought on by other unanticipated forces.

Many banks will advance up to 100 percent of the cost of livestock if the borrower has sufficient feed on hand and a sound overall financial position. Since the animals gain weight and value as feedstocks are consumed, the bank's collateral position normally strengthens as the livestock matures toward market weight. For borrowers without adequate feedstocks on hand, advance rates may be limited to 70 to 80 percent of the purchase price.

## TYPES OF LIVESTOCK OPERATIONS AND LOAN CONSIDERATIONS

Livestock producers usually specialize in particular kinds or breeds of animals or in certain phases of an animal's life cycle. This specialization may vary depending on geographic area, climate, topography, soil type, or the availability of water and feed, or on the producer's preferences, experience, or physical facilities. A producer may change his specialization from time to time based on recurring market cycles or more fundamental shifts in economic factors, such as consumer demand. Some producers are involved in more than one type of livestock operation at any given time.

The following is a brief discussion of the most common types of livestock operations, as well as the lending and loan analysis considerations for each.

### Cattle

#### *Beef Breeds*

- *Cow-calf operation.* A producer has breeding stock that produces calves, which are then sold as either feeder calves or future breeding stock or are kept until the animal reaches full maturity.

The typical cow-calf loan is for financing the breeding stock (cows and bulls) of a herd. The loan term is usually three to five years, with annual payments of principal and interest to fully amortize the loan within that term. Often, loans for this type of operation are written with one-year maturities and no predetermined amount of principal reduction at maturity. However, this kind of loan structure is more suitable for borrowers who are not highly leveraged.

Repayment is from the annual sale of calves and cull cows (older cows or those that fail to produce offspring). Approximately 10 to 15 percent of a cow herd is culled each year; most cows are retained for seven to as many as twelve years. Bulls are typically stocked at one for each 20 to 25 cows; pregnancy rates are generally 80 to 100 percent, depending on the age and health of the cows and on feed availability.

Most calves are born in late winter and early spring, weighing around 100 pounds. Cows may be winter-fed on hay, but cows and calves graze on pastureland from spring to around October when the calves weigh 500 to 550 pounds. At this time, the calves may be sold to another producer who specializes in raising stockers. (However, in some areas, herds are managed to produce fall calves. Also, depending on feed sources and market conditions, calves may be sold at lighter weights, around 300 to 400 pounds.)

- *Stocker or backgrounding operation.* A producer in a stocker operation acquires calves weighing from 300 to 550 pounds and feeds them, primarily on pasture, until they weigh around 700 to 750 pounds, when they are sold to a finisher. Since the growth gains of young cattle are generally the most efficient phase of beef production, some stock operators prefer to buy lighter weight calves, although the lighter weights require more care and supervision to minimize death losses. Stocker operations are relatively high-risk programs that require specialized knowledge, but they can also be quite profitable.

Backgrounding requires approximately 100 days, during which time the cattle may be fed a daily ration of silage (the entire corn or grain sorghum plant chopped into feed and stored in a silo) and grain and feed supplements, including soybean meal, minerals, salt, and vitamins. The supplements usually need to be purchased. Steers gain approximately two pounds per day, and heifers slightly less. Sometimes stocker cattle are placed on pasture, which can include dormant wheat in the winter or grass during the summer.

Stocker cattle are typically financed with a 90- to 120-day single-advance, single-maturity note. Funds for feed purchases may be provided as part of the note proceeds, but, more commonly, the feed is raised by the producer. Loan repayment comes from the sale of the cattle when they weigh around 700 to 750 pounds. Collateral for stocker loans is typically the cattle financed and the feed. Banks usually require around a 30 percent margin in the cattle, but may require as little as 20 percent or less for financially strong borrowers.

The profitability of a backgrounding operation is sensitive to the average daily weight gain, feed costs, weather, and purchase and sale prices of the cattle.

- *Finishing operation.* A finishing operation acquires cattle weighing approximately 700 to 750 pounds and feeds them a high-protein grain ration until they are ready for slaughter at around 1,100 to 1,200 pounds.

Finishing usually takes around 130 to 145 days. Most finishing cattle are now custom-fed in commercial feedlots, but the producer (not the feedlot owner) usually retains ownership of the cattle. Feeder steers usually gain approximately 3.2 pounds per day, and heifers around 2.8 pounds per day. However, average daily gains vary depending on the breed, type of ration, time of year, or weather conditions.

Finishing cattle can be risky because of fluctuations in cattle prices between purchase and sale dates. Some producers use futures contracts to lock in prices and reduce the risk, or they enter into forward contracts with a packer. Larger producers may use a “moving hedge” to offset the risk imposed by market cycles.<sup>2</sup>

Banks normally require 20 to 30 percent initial margin in financing the purchase of feeder cattle, but may advance up to 100 percent of the feed costs. As the cattle gain weight, the bank’s collateral position tends to improve. Repayment comes from sale of the cattle, with loan maturity set near the anticipated sale date.

### *Dairy Operations*

Cows are milked for ten months each year, then rested for two months and allowed to “dry up” (quit producing milk by not being milked). Three months after a female dairy cow gives birth, she is rebred and calves nine months later. Cows are commonly bred through artificial insemination, which allows the producer to improve the genetics of the herd. Each year approximately one-third of the cows are culled,

2. In this strategy, the producer periodically buys a given number of lightweight feeders and at the same time sells a similar number of fat cattle. When prices are down, lower revenues from sales of cattle are offset by the benefit of lower costs to purchase replacement lightweight feeders. By the same token, when prices are up, higher purchase costs are offset by higher revenues on the slaughter cattle sold. This strategy allows the producer to prevent or substantially minimize losses due to fluctuating market prices. Otherwise, the producer might too often be in the position of only buying at high prices and only selling at low prices.

with replacement heifers usually raised on the farm. An 80 percent calf crop is common, with the males either sold soon after birth or fed for slaughter.

Milk production is measured by pounds of milk produced per cow per year. Production in the range of 13,500 to 20,500 pounds is common. Milk production variables include the quality of the cows, number of days milked each year, and amount and quality of feed. Feeding cows a higher ratio of grain to dry hay will result in higher milk production, but the higher feed costs must be weighed against the returns of higher production.

Feed is a major expense for a dairy operation. Dairy cows consume a ration of corn or grain sorghum, soybean meal, high-quality hay, silage, vitamins, and minerals. Family-oriented dairy operations usually grow most of their own feed on the farm, while larger operations purchase most of their feed and confine the cows to a dry-lot facility.

A dairy operation is heavily capital intensive because of the investment in cows, buildings, and equipment. Dairying is also labor intensive, which further adds to the cost of production.

The efficiency of a dairy operation is measured on a "per-cow" basis. Gross income, expenses, and net income can be divided by the number of cows to analyze trends and compare them with other dairy operations. Several other key indicators of a dairy operation's productivity include the following:

- *Pounds of milk per cow per year.* Herds averaging less than 14,000 pounds may be struggling.
- *Calving interval.* Twelve to thirteen months is favorable; if the interval lengthens, milk production and the overall efficiency of the operation will decline.
- *Calf losses.* A 10 percent or less loss on live calves born is favorable and considered an indication of good management.
- *Culling rate.* Cows should start milking when they are about two years old and should average four to five lactation periods before they are culled; if cows have to be culled prematurely, efficiency declines.

Loans to dairy operators may include longer-term financing for land and improvements; intermediate financing for the cow herd, specialized equipment, and vehicles; and operating loans to help finance the production of feed

crops. Established operations may not require herd financing unless the herd is being expanded. Financing replacement cows to maintain a herd, if necessary, should be included in a shorter-term operating loan. Generally, operating loans are not a major financing activity as the dairy farmer's regular income from the sale of milk can often accommodate operating needs.

Collateral for dairy loans, in addition to real estate, typically includes the livestock, crops and feed on hand, and equipment. The collateral is usually covered with a blanket security agreement. Often, milk sale proceeds are assigned to the bank, and the milk buyer sends a monthly check directly to the bank to meet scheduled loan repayments.

Clearly, the primary source of income for the dairy farmer is the sale of milk, which is produced daily. Additional income is produced from the annual sale of calves and culled cows.

## Hogs

Hog production consists of a two-stage operation: (1) "farrowing" (breeding sows to produce feeder pigs) and (2) "finishing" (fattening feeder pigs to slaughter weight). Many producers combine both enterprises and are called farrow-to-finish operations.

Hog producers range from small operators to large corporate interests. The small producers can be considered those who market less than 2,500 head per year; they can be involved either in finishing hogs or in farrow-to-finish operations. Small producers also tend to be involved in grain farming (raising their own feed) and other kinds of livestock production. The profitability and financial strength of a small producer is generally tied to the ability to market hogs frequently throughout the year, which lessens the impact of adverse market fluctuations. If the producer cannot market frequently, he or she probably needs to be involved in hedging practices. A corporate hog farm is usually a farrow-to-finish operation, with the number of sows ranging from 500 to as many as 100,000 for the largest producers.

### *Farrowing Operations*

Hog breeding normally requires one boar for approximately 20 sows. Sows typically have

two litters per year, and litter size is one of the most crucial factors in determining the success of a farrowing operation. Eight hogs per litter is a goal for most producers. Up to 25 percent of the sows will be culled each year. Some producers raise their own replacement sows, while others purchase quality breeding stock in an attempt to improve herd quality.

Pigs are farrowed (born) in confinement buildings, and after three weeks, they are moved to a nursery facility where the pigs are weaned from the sow. The capital invested in farrowing facilities varies greatly, but the trend has been toward higher investments in facilities that require less labor. However, a large investment in a single-use, costly hog facility can pose a significant risk if the farrowing operation is not profitable.

Feed costs are the largest operating expense of a farrowing operation. The feed required consists of a feed grain (corn or milo), a protein supplement, vitamins and minerals, and a pig starter (a commercial feed used in the transition from nursing to eating solid food). In a feeder pig production operation, the young pigs are typically kept until they weigh 40 to 60 pounds, which takes around two months. Feed costs are continually changing because of fluctuating grain prices, so it may be difficult to project cash flow accurately. Historical cash flow may be more useful in demonstrating the borrower's overall management capabilities.

Loans to farrowing operations may include an intermediate- to mid-term loan on the facilities (usually not for more than ten years), breeding stock loans that should be amortized over no more than four years, and operating loans. Operating loans are often in the form of revolving lines of credit to purchase feed, with repayment normally coming from the sale of hogs. The operating line should be cleaned up periodically, or the bank should establish systems to monitor advances and repayments to ensure that stale debt is not accumulating.

Collateral for a farrowing operation could include the facilities and the hogs and feed on hand. For collateral purposes, the hogs should be valued at local market prices even though the producer might have paid a premium for breeding stock. Feed should be heavily margined, as the proceeds from feed sale during a foreclosure are likely to be limited.

Loan repayment comes primarily from the sale of young feeder pigs and culled sows. The timing of scheduled repayments will vary,

depending largely on the producer's breeding schedule and the anticipated sale dates for feeder pigs. Usually, sows are bred at different times so they are not all having pigs at the same time. In the case of a farrow-to-finish operation, the cycle will be longer, and repayments will be scheduled according to anticipated sale dates of the fat hogs and culled breeding stock.

### *Finishing Operations*

Hog finishing is the process of acquiring young pigs that weigh 40 to 60 pounds, and feeding them until they reach a slaughter market weight of 220 to 240 pounds. The process takes approximately four months. The average death loss for a finishing operation is generally 4 to 5 percent of the total number of hogs started on feed.

Loans for hog finishing are usually in the form of single-payment notes that mature in approximately four months. Loan proceeds are used to purchase young pigs and may also be used to purchase feed. A bank commonly advances up to 100 percent of the purchase price of the pigs. Usually, there is a blanket security agreement in place that gives the bank a security interest in all hogs, as well as in feed and other chattels to provide additional overall support for the credit. Margin in the collateral increases as the animals gain weight. Repayment comes from the sale of fat hogs to a packing plant.

The main factors in determining a finisher's profitability are (1) the cost of the feeder pigs, (2) the cost of feeding the pigs, and (3) revenues from the sale of hogs. Costs and revenues continually change because of fluctuations in market prices for young pigs, slaughter hogs, grain, and feed. Because of the relatively short cycle of hog finishing, a number of loans may be made during one year. In analyzing hog loans, reviewing the overall profitability of the operation (taking into account depreciation on facilities and equipment, interest, and insurance) is more meaningful than reviewing the results from each individual loan advance.

## Sheep

Sheep are raised for the production of meat and wool. The most common sheep enterprise is the raising of ewe (female) flocks, which produces

income from the sale of both wool and lambs. Larger flocks tend to be more efficient as they can take better advantage of investments in labor-saving equipment.

Ewes give birth once a year, usually during late fall or winter. They frequently have twins, resulting in an overall lamb production per ewe of approximately 140 percent. About 20 percent of the ewes are culled each year, with replacements usually being raised from lambs. There is typically one ram for each 30 ewes in a breeding flock. The sheep and lambs graze on pasture during the summer and are fed a ration of roughage and grain during the winter.

Loans to ewe flock operators are made to purchase breeding stock and to pay operating expenses. Breeding-stock loans should be amortized over no more than five years. Repayment comes primarily from the sale of lambs and wool.

Typically, lambs are finished in commercial feedlots until they reach slaughter weight, which involves purchasing 60-pound feeder lambs and feeding them a hay-grain ration for about 90 days until they weigh approximately 120 pounds. The loan term is usually 90 to 120 days, with the sale of fat lambs to a processor being the source of repayment. Collateral consists of the lambs, which should be valued at local market prices. Margin required in the lambs, if any, will depend on feedstocks owned or on the borrower's financial strength.

## Poultry

Poultry production has become a very large and highly organized agribusiness. Large corporate producers dominate the industry. However, they depend to a large extent on individual growers, with whom they contract to raise the birds almost from the day they are hatched until they are ready for slaughter. The large company supplies an independent grower with the day-old chicks, feed, and medications and provides technical support. Under the contract, the company pays the grower at a rate designed to provide an acceptable return on the grower's investment in poultry houses, equipment, and labor.

Producing breeding stock, incubating eggs, hatching chicks, and producing pullets and eggs are other aspects of the poultry industry that are highly specialized and relatively concentrated

within fairly large corporate producers. Most banks will not extend loans on these types of operations, and any that do should have substantial background information on the industry in their files. The examiner should review that information and discuss the industry and the borrower's operation with the officer originating or servicing the credit.

The typical grower owns 60 to 80 acres of land and has an average of three to four poultry houses. Most growers also have other jobs and earn supplemental income from their growing operations. Broiler (or fryer) chickens generally are grown to a live market weight of approximately 4.2 pounds at 42 days of age.

Most bank loans to contract poultry growers consist of construction loans to build poultry houses and permanent financing for the houses and equipment. The houses are large but of relatively simple construction. Permanent financing is typically amortized over 10 to 15 years.

Government guarantees (Farmers Home Administration, Small Business Administration, or various state agencies) are often available to mitigate the bank's risk by guaranteeing from 85 percent to as much as 100 percent of the permanent loan. Federal guarantees have not been available for construction financing of poultry houses, so the bank generally will have to assume the full risk of the loan during the construction period.

Construction loans are generally converted into long-term loans that are repaid with the contract income a grower receives from the large corporate producer. Since feed and other supplies are typically furnished by the large producer, individual growers do not normally require operating loans.

Egg production for consumption (rather than hatching) is another aspect of the poultry industry; it is also highly organized and controlled by large producers. Facilities, feed, and labor represent the primary costs for these operations, with repayment coming primarily from the sale of eggs. Some income is also derived from the sale of "spent" hens (older hens that are no longer efficient layers). These operations are capital intensive and highly specialized. Loans to egg producers need to be carefully analyzed to determine whether they are properly structured and adequately margined. Assessment of the borrower's overall management ability, and record of profitability, industry trends, and any special risk factors is particularly important in judging loan quality.



## OPERATING (PRODUCTION) LOANS

Banks (and other lenders) commonly finance the operating expenses of agricultural producers with short-term operating loans. Expenses financed may include items such as cash rent; seed; fertilizer; chemicals; irrigation; fuel; taxes; hired labor; professional fees; and, for a livestock producer, feed, feed supplements, veterinary care and medicines, and other supplies. Operating loans may take the form of single-purpose financing or line-of-credit financing. The single-purpose loan is the simplest and most basic form of financing, as it does not attempt to address the borrower's total credit requirements, and the repayment source and timing are relatively certain.

Line-of-credit financing may accommodate most of a borrower's operating needs for the production cycle. Advances are made as needed to purchase inputs or pay various expenses, with all income usually remitted to the lender to reduce the line. Depending on the type of operation, the line may seldom be fully retired because funds are advanced for a new operating year before all inventories from prior years are marketed. An operating line of credit is generally established after cash-flow projections for the year are made to anticipate credit needs and repayment capacity. While this type of financing has the advantages of convenience and accurate cash-flow monitoring (which permits comparing actual cash flow with projections), it can also have some disadvantages. The lender may be inadvertently funding or subsidizing other creditors' payments with advances on the line and, because operating cycles overlap, it may be difficult for the lender to get out of an undesirable situation.

An operating line may be revolving or non-revolving. A revolving line replenishes itself as repayments are made, so the outstanding balance can fluctuate up and down during the approved term. There is no limit on the total amount borrowed during the term of the line, as long as the amount outstanding never exceeds the established limit. A nonrevolving line is structured so that once the approved amount is used, even though payments are made to reduce the line, the borrower must reapply and receive approval for any further advances. Revolving lines afford flexibility but have no firm disbursement or repayment plan, so they

are usually reserved for borrowers with strong financial positions, proven financial management, and a history of cooperation and performance. Bank management should continually monitor operating lines and clearly document the purpose for advances and source of repayments. A clean-up period may or may not be required after harvest or completion of the operating cycle, depending on the anticipated schedule for selling farm or ranch production.

The primary source of repayment for an agricultural operating loan is revenue from agricultural production. Many farmers also receive some form of government support payments, and they may have employment off the farm or do custom work (such as harvesting) for hire. In many cases, wages or salaries generated from the nonfarm employment of a farmer's spouse will cover a significant portion of the family's living expenses, relieving the financial pressure on the farming operation. To evaluate repayment capacity, the loan officer must determine how much revenue will be generated from either current production or inventories. Revenues will need to be sufficient to cover all expenses, however, not just those funded by the loan. These could include various operating expenses, family living expenses, payments on capital debt (for real estate and equipment), and any anticipated new capital expenditures. There should also be a margin to cover incorrect assumptions about yields and prices.

Most agricultural lenders recognize the need for yearly cash-flow projections to help determine credit needs and repayment capacity. Projections of both income and expense are usually made for each month (or each quarter) of the year to anticipate the amount and timing of peak financing needs, as well as the total net cash flow for the year. Obtaining and analyzing yearly federal income tax returns (particularly Schedule F) should be strongly encouraged as a means of reviewing actual operating results. Actual data can then be compared with projections to determine variances. Reasons for the variances should be understood as a part of the credit analysis process. This analysis will help the bank decide whether to grant or deny credit and service loans.

If a borrower loses money from operations in one year and cannot fully repay the operating loan, there will be "carryover debt." In general, carryover debt should be segregated, secured with additional collateral if possible, and amortized over a reasonable term that is consistent

with the borrower's repayment capacity. Consistent losses and excessive carryover debt can preclude further advances and lead to the sale of certain assets or even to full liquidation of the operation.

Collateral for a typical operating loan includes growing crops, feed and grain, livestock, and other inventories. Normally, a bank also obtains a security interest in equipment, vehicles, government payments, and other receivables to strengthen the collateral margin. For new borrowers, a lien search is recommended to determine the presence of any senior liens. Pledged assets should be valued, either by a knowledgeable bank officer or an outside appraiser, and the operation and collateral should be inspected periodically to judge conditions and values. Inspections for established borrowers are usually done at least annually. More frequent inspections are usually performed on marginal borrowers or if the borrower has a feeder livestock operation with more rapid turnover of assets.

## GOVERNMENT AGRICULTURAL SUBSIDY PROGRAMS

Federal government programs have long been able to help farmers financially and, to an extent, control the overproduction of agricultural products. These programs are continually evolving, but remain important in determining many producers' income levels and profitability. In addition to establishing subsidies, the programs also set limits on the number of acres of certain crops that a producer can plant to help control crop surpluses and support price levels.

### Conservation Reserve Program

The Conservation Reserve Program (CRP) is a long-term retirement program for erodible land. Landowners submit bids for a 10-year contract, stating the annual payment per acre they would accept to convert the highly erodible land to a grass cover. The maximum bid per acre has been established, and accepted bids must not exceed prevailing local rental rates for comparable land. If the bid is accepted by the local Agricultural Stabilization and Conservation Service (ASCS) office, the landowner must sow the land to grass, with the cost of planting grass shared by the landowner and the government.

During the term of the 10-year contract, the landowner cannot plant a crop on the land, allow grazing on it, or cut the grass for hay. The CRP contract is assignable, so it can be transferred to a new owner along with title to the land.

## Farmers Home Administration

The Farmers Home Administration (FmHA) is a federal lending agency operating within the U.S. Department of Agriculture. The FmHA performs two main functions: (1) providing supervised credit to farmers who are unable to obtain adequate credit from commercial banks and (2) improving rural communities and enhancing rural development.

Three basic programs allow the FmHA to extend funds to farmers: (1) grants, (2) direct loans, and (3) loan guarantees. The grant program is the smallest and generally relates to rural housing and community programs, most of which are for water and waste disposal systems. The direct loan programs are for loans made by FmHA through its county and state offices to farmers. The loan guarantee program permits the FmHA to guarantee up to 90 percent of the amount of loss on a loan made and serviced by another lender.

Most FmHA loans are (1) farm-operating loans, (2) farm ownership loans, or (3) emergency farm loans. Operating loans and farm ownership loans are for operators of family farms. Eligible purposes for operating loans include capital loans for machinery and livestock, as well as annual production inputs. Farm ownership loans are available for buying land, refinancing debts, and constructing buildings. Emergency loans are designed for farmers in counties where severe production losses have resulted from a disaster or from economic emergencies.

To qualify for a loan, a borrower must (1) be unable to obtain sufficient credit elsewhere at reasonable rates and terms, (2) be a citizen of the United States, (3) be an owner or tenant operator of a farm not larger than a family farm, and (4) have sufficient training or experience to ensure a reasonable chance of success in the proposed operation.

Banks have been highly motivated to use the FmHA-guaranteed loan program as a means of mitigating risk and perhaps developing a sound customer for the future. An FmHA loan also

improves the bank's liquidity, since the guaranteed portion of the loan can be sold in the secondary market.

## Small Business Administration

While it is not primarily a lender to agricultural producers, the Small Business Administration (SBA) has made low-interest-rate disaster loans available to individuals, including farmers. The SBA can make or guarantee various types of agricultural loans to producers whose annual revenues do not exceed \$500,000. Banks occasionally make these loans, which are supported by collateral as well as a substantial percentage guarantee by the SBA. In many rural areas, however, it is probably more convenient for a bank to work with a nearby FmHA office than with an SBA office, which may be located some distance away in a metropolitan community.

## Federal Crop Insurance Corporation

The Federal Crop Insurance Corporation, which is a part of the U.S. Department of Agriculture, writes multiperil crop insurance. The premiums for this insurance are subsidized by the federal government. For further information, see the following subsection on crop insurance.

## CROP INSURANCE

The Federal Crop Insurance Reform Act of 1994 combined crop insurance and disaster aid into a single, unified program. To be eligible for any price support or production adjustment program and for new contracts in the conservation reserve program or any FmHA loan, farmers must carry crop insurance coverage. The expanded crop insurance program replaces the need for disaster bills as the federal response to emergencies involving widespread crop loss.

Aside from the basic required coverage under the federal program, known as the catastrophic coverage level, banks encourage some borrowers to carry crop insurance to reduce their risk of not being repaid on farm-operating loans. Borrowers that are more highly leveraged and have minimum margin in their operating loans are most likely to be required to carry crop insur-

ance. Two common types of crop insurance are (1) crop hail insurance sold by private insurers, which insures only against hail damage, and (2) multiperil crop insurance written by the Federal Crop Insurance Corporation. As its name implies, multiperil crop insurance insures against drought, rain, hail, fire, wind, frost, winterkill, disease, and insect losses.

The federal government subsidizes the multiperil crop insurance premium by paying most of its administrative, actuarial, underwriting, and selling expenses. By subsidizing premiums and encouraging more producers to purchase the insurance, the government hopes to reduce the dependency on crop disaster payments when natural disasters occur. However, this program has not been particularly popular with farmers because they would have to suffer a high level of losses on all planted acres to receive any significant proceeds from the insurance. By diversifying their crops and planting in fields that are separated by significant distances, many farmers are willing to risk planting without crop insurance.

## EVALUATING AGRICULTURAL MANAGEMENT

A crucial factor in loan analysis for banks, as well as for examiners, is an evaluation of the management capabilities of the agricultural producer. Cash earnings from an operation provide the primary source of repayment for most agricultural loans, so it is important to evaluate the borrower's ability to manage a profitable operation. The three kinds of management that agricultural lenders most often analyze are production, marketing, and financial management.

## Production Management

A lender should first assess the borrower's technical ability as a producer of crops or livestock. This is primarily an objective measure because it consists of comparing an operation's output against industry and area norms. An operator whose production levels are consistently below average will probably have difficulty meeting debt-service requirements and may not be able to stay in business. There may be justifiable reasons for occasional years of below-average production, but lenders should

be cautious of operators who consistently perform poorly.

Another factor to consider is the producer's ability to successfully cope with the inherent variability of agricultural production. Adverse weather, disease, and pest infestations are all production risks that continually affect crops and livestock. Some producers diversify the commodities they produce to reduce their dependency on one crop or type of livestock.

## Marketing Management

Good marketing management enables the producer to reduce price risk exposure. Volatile markets have convinced most producers and lenders that sound marketing is crucial for an ongoing agricultural operation, and almost every producer needs a marketing plan designed to control price risk. Aside from helping to ensure profitability, the plan can be incorporated in formulating a more reliable statement of projected cash flow, which helps both the lender and producer anticipate financing needs.

Some of the techniques that producers use to manage price risk exposure are forward contracting, hedging, purchasing options, and using government programs. See the subsection "Marketing Farm Products" for details.

## Financial Management

A producer should have the ability and willingness to understand, maintain, and use financial records. The importance of sound financial records began to be more fully appreciated in the 1980s when agricultural loan losses rose, and many agricultural producers and banks failed. During that time, the primary emphasis for many agricultural lenders shifted from collateral-based lending to cash-flow lending. While collateral may afford ultimate protection for the lender under a liquidation scenario, cash flow allows for repayment of debt in the normal course of business.

In addition to recordkeeping, financial management also encompasses how a producer uses his or her assets and liabilities. Maintaining financial reserves in the form of current assets is one means by which a producer can be prepared to overcome short-run adversity. The reserves need not necessarily be cash; they might be in

the form of stored grain or other nonperishable produce or they could be earning assets such as livestock, which is readily marketable. Controlled, reasonable equipment purchases are another indication of good financial management. Overspending on equipment may be indicated if the borrower's equipment list includes many items that are new, especially costly, duplicative, or unneeded for the types of operations being conducted. The presence of sizable nonbank equipment debt on the borrower's financial statement can, in some cases, also reflect overspending.

## MARKETING FARM PRODUCTS

Marketing considerations have become more important for many producers as they attempt to maximize returns. Rather than merely selling crops or livestock at prevailing market prices when the production cycle is complete, some producers attempt to lock in a price through the use of forward contracts or futures or options trading. Some producers of nonperishables may simply study market action and cycles and keep harvested crops in storage, waiting for higher prices. Some livestock producers may buy and sell throughout the year to help even out the effects of market fluctuations. Both the bank lending officer and the borrower need to have a clear understanding of the marketing plan, including its potential costs, benefits, and risks.

The following comments briefly describe some of the basic tools producers use as alternatives to the cash market to manage price risk.

- *Forward contracting.* The producer contracts with a buyer to sell farm products at a fixed price in advance of the actual marketing date. These contracts are simple to use if willing buyers can be found, but carry some risk of the buyer's defaulting, particularly if market prices decline significantly before the contract matures. This risk may be mitigated to some extent by requiring the buyer to provide security in the form of a 10 to 15 percent margin to help ensure that the buyer honors the contract.
- *Minimum-price forward contract.* This is a relatively new type of forward pricing that may be available to some producers. It establishes a floor but not a ceiling for the price the producer will receive for his commodities, so

it protects against price declines but permits the producer to garner additional profits if the market rises.

- *Basis contracting.* This is a variation on forward contracting, whereby the price the producer receives is not fixed when the contract is drawn, but will be determined by the futures market price plus or minus some agreed-on difference (basis). For example, cattle for September delivery might be priced at the September futures price (as of a date to be selected by the seller) plus 50 cents per hundredweight. Accordingly, a basis contract does not reduce risk until the price is set by the seller, so if the seller waits to set the price, he or she is still subject to all market risk. However, a basis contract can be combined with a put option (see below) to set a minimum price.
- *Hedging.* Hedging involves the use of counterbalancing transactions to substantially eliminate market risk. The type of hedge typically used by an agricultural producer is sometimes referred to as a “short hedge” because it involves use of the futures market to, in effect, sell short. Later, when the producer’s commodities are ready for delivery, he sells them in the cash market. If the price has declined, he makes a profit on the sale of the futures contract to offset the lower price he receives in the cash market. Conversely, if the price has increased, a loss on the futures contract will be incurred to offset the gain in the cash market. Hedging is similar to fixing a price with a forward contract except that the price is said to be an “expected” fixed price, since the difference between the cash and futures prices may not be correctly anticipated and the resulting net price received will vary some from the expected level. Hedging can have an advantage over forward contracting because it is readily available and based on competitively determined futures prices. Since positions in the futures market require the producer to keep a cash margin with the broker, and additional margin calls may have to be met if the market goes up (after the producer has sold short), it is especially important that the bank loan officer be aware of and understand the borrower’s marketing plan.
- *Put option.* Buying a put option gives the producer the right, but not the obligation, to sell a commodity at a given (strike) price any time before the put’s expiration date. It protects against falling prices because the put

becomes more valuable as prices fall. At the same time, a put allows the producer to benefit from rising prices, if they rise more than enough to cover the cost of the put. Puts can also be attractive because they can limit losses by establishing a minimum price at times when current prices are not profitable and the producer is reluctant to fix a low price with forward contracting or short hedging. Puts have the disadvantage of being more expensive than hedging; premiums for put options can be especially high when market prices are high.

Other more complex strategies are sometimes used that combine cash and futures instruments to minimize risk or to modify initial positions to adjust for changing market conditions, including the following.

- *Establishing minimum prices with basis contracts.* Purchasing a put option along with selling commodities on a basis contract establishes a minimum price, while allowing the producer to gain from rising prices.
- *Converting a fixed price into a minimum price.* If a producer accepts a fixed price via forward contracting and later regrets that decision, he or she may decide to purchase a call option (which becomes more valuable as prices rise). The combination of a fixed-price contract and a call option is called a “synthetic put” because the net effect is the same as buying a put option. The producer who has accepted an estimated fixed price via a short hedge can either lift the hedge (cover the open short sale in the futures market) or, depending on circumstances and relative costs, leave the hedge in place and purchase a call option.
- *Converting a minimum price into a fixed price.* If a put option has been used to set a minimum price at very low levels, and prices subsequently increase, the producer can either roll up the put to a higher strike price or sell futures and establish a fixed price when the market reaches an acceptable level. Buying one or a series of additional puts allows the producer to profit from a further rising market but may become expensive.

## FINANCIAL AND INCOME INFORMATION FOR AGRICULTURAL PRODUCERS

The financial and income information most

commonly used by agricultural lenders includes balance sheets, income tax returns, and statements of projected cash flow. Many producers do not prepare income statements on an accrual basis. Often, their only available income statement is Schedule F of the annual federal income tax return.

## Balance Sheet

Balance sheets for agricultural producers usually divide assets and liabilities into three groups—current, intermediate, and long-term—based on the liquidity of assets and repayment schedules of liabilities. Current assets are those that will either be depleted within 12 months or can easily be converted to cash without affecting the ongoing business operation. Current assets include cash, accounts receivable, livestock held for sale, inventories of crops, feed, supplies, growing crops to be harvested within 12 months, and prepaid expenses.

Intermediate assets support production and may be held for several years. Principal intermediate assets include breeding stock, equipment, and vehicles. While these assets may be relatively liquid, their sale would seriously affect the productivity of the operation.

Long-term, or fixed, assets are more permanent in nature and benefit the operation on an ongoing basis. The principal fixed asset of an agricultural operation is farm real estate, although the producer may have other long-term assets, such as investments, which may or may not be related to his or her farming or ranching operation.

Current liabilities include those which must be paid within 12 months, including amounts owed for feed, seed, supplies, interest, and taxes. The amounts of any payments due within 12 months on intermediate-term and long-term debt should also be included in current liabilities.

Intermediate liabilities are generally those due between one and ten years from the statement date, and commonly represent debt to finance equipment and vehicles. As mentioned above, the amounts of payments due on these debts within 12 months are shown as current liabilities.

Long-term liabilities usually are those that, at inception, had a maturity of more than ten years. Debt on real estate is the main type of long-term liability on the balance sheets of most agricultural producers.

The difference between total assets and total liabilities is the net worth of the producer or the equity in the producer's assets. Most producers are individual or family farmers whose balance sheets also include personal assets not directly used in the operation, as well as debts owed on those items.

It is important to remember that the amount shown on the statement for net worth is subject to question. Since it is merely the difference between the amounts shown for total assets and total liabilities, its accuracy depends on how the assets are valued and whether all liabilities are reflected. Most agricultural borrowers value assets on their balance sheets at what they assume to be "market value." However, some tend to use rather optimistic valuations, particularly on items such as equipment and real estate. Also, some borrowers tend to carry the same values forward each year for real estate or equipment, which may cast some doubt on accuracy. Examiners reviewing agricultural credits should try to determine prevailing market prices for various types of land in the bank's trade area and acquire general knowledge of equipment values. Recent published sales data on both real estate and equipment provide reliable indications of current values.

Sometimes not all liabilities are fully or properly disclosed. A form of potential liability that is often not disclosed is the amount of deferred income tax that will be due on the sale of real estate in which the borrower may have a substantial unrealized capital gain. It may not be possible to readily estimate such deferred-tax liability unless the borrower's statement shows both cost and market values. However, the examiner should keep these points in mind in analyzing the balance sheet, in an attempt to accurately assess the borrower's financial strength. Comparison with previous balance sheets, other information in the loan file, and general knowledge about values will aid the examiner in this analysis.

It is advisable to determine how the balance sheet was prepared and by whom. Many are prepared by the borrower and submitted to the bank. Others may be prepared by the borrower and lending officer working together. Presumably, the latter method would tend to ensure a more accurate presentation but, if not, it could raise questions about lending practices or the lending officer's competency. Similarly, balance sheets that do not balance (not an unusual

occurrence) might indicate a lack of appropriate analysis by the lending officer.

### *Balance-Sheet Ratio Analysis*

The following are some basic, fairly simple ratios that can indicate the financial strength of a producer.

- *Current ratio (current assets/current liabilities)*. This ratio can reflect a borrower's ability to meet current obligations without additional borrowing.
- *Quick ratio (liquid assets/current liabilities)*. This ratio compares current assets that are easily converted into cash with current obligations and reflects a borrower's ability to immediately meet current obligations.
- *Leverage ratio (total liabilities/net worth)*. This ratio shows the relationship between borrowed capital and owned capital. The higher the ratio, the greater is the reliance on borrowed capital, which means higher interest expense, potentially lower net income, and certainly less equity cushion to withstand risk and adversity. This is often called the *debt-to-worth ratio*.

### *Ratio Interpretation Guidelines*<sup>3</sup>

<i>Ratio</i>	<i>Low Risk</i>	<i>Mod- erate Risk</i>	<i>High Risk</i>
Current Ratio	1.5:1	1:1–1.5:1	<1:1
Quick Ratio	1.1:1	.8:1–.5:1	<.5:1
Leverage Ratio	.75:1	1:1	1.25:1

### **Income Statement**

Determining actual profitability for most agricultural borrowers is difficult, primarily because of the absence of complete income and expense information on an accrual basis. The most common income statement for agricultural producers is Schedule F of the federal income tax return (“Profit or Loss from Farming”), which

3. These ratio interpretation guidelines are only rules of thumb and need to be viewed in conjunction with a thorough analysis of other pertinent factors, including balance-sheet composition, the nature of the operation, and an assessment of the borrower's management ability.

accompanies Form 1040. It is prepared on a cash basis, showing cash income received and cash expenses paid, although the taxpayer is also permitted to deduct depreciation expense for items such as equipment, improvements to real estate, and breeding stock. Farmers may have other farm-related income reported on Form 4797, which reports sales of dairy and breeding livestock, or on Schedule D, which shows sales of real estate and equipment. Additional nonfarm income is reported on page 1 of Form 1040. All sources of income need to be considered by lenders and examiners, but for most farm borrowers, Schedule F is the primary report of income for the farming operation.

Tax returns probably provide the most accurate income and expense information for most farm operations. Some lenders attempt to convert the cash basis Schedule F to an accrual basis by adjusting for changes in inventory values, receivables, payables, and similar items, but the process requires timely, detailed financial information that often is not readily available. Instead, many lenders and examiners look at cash-basis income over a three-to-five year period to analyze trends and even out the cash-flow variances caused by differences in production and marketing cycles.

While cash income is not necessarily a good measure of farm business profits, it does help show the cash-flow situation and is useful in planning debt repayment programs and family budgets. In addition, cash income statements can be compared with projected cash flows to determine variances that need explanation or that may indicate the need for changes in the operation.

### *Operating Ratio Analysis*

Key ratios can be calculated from income statements to aid in analysis. The most commonly used ratios measure profitability, repayment ability, and efficiency. Profitability is usually determined by return on equity and return on assets. Repayment ability can be determined by the earnings coverage ratio and debt payment ratio. The most common economic efficiency ratio used is the operating expense to revenue ratio. Although many smaller banks have not used income statements to any extent to analyze agricultural credits, this type of analysis can provide useful insights into an operator's efficiency and repayment ability.

Return on assets is usually calculated by adding interest expense to net farm income and deducting a management fee (usually an amount for unpaid family labor), then dividing the resulting figure by average total farm assets for the year. Return on equity is usually calculated by deducting a management fee or unpaid family labor from net farm income and dividing the difference by total farm net worth.

Common ratios used to assess debt repayment ability and repayment risk are the earnings coverage ratio and the debt payment ratio. The earnings coverage ratio (also known as the cash-flow ratio) is a measure used to assess the operation's ability to repay. A strong earnings coverage ratio would be 30 percent or above. An acceptable but riskier level would be 10 to 30 percent. The debt payment ratio is used to determine risk over the term of the loan. It is calculated by dividing total annual debt payments by total revenue. As a general rule, total principal and interest payments should not exceed 25 percent of total revenue. A ratio of less than 15 percent would be relatively safe, while a 15 to 25 percent range would indicate some degree of risk.

The operating expense to revenue ratio measures the operating efficiency of the farm exclusive of debt obligations. A ratio of less than 70 percent usually reflects an efficient manager who can service larger amounts of debt. If the ratio exceeds 80 percent, repayment problems could occur if large amounts of debt are outstanding. The ratio tends to be higher for smaller operations.

The following example shows how the earnings coverage, debt payment, and operating expense to revenue ratios are determined from the income statement. This example reflects generally adequate ratios.

1. Total farm revenue	\$210,000
2. PLUS: Nonfarm revenue	22,000
3. Total revenue (line 1 + line 2)	232,000
4. LESS: Farm operating expenses (excluding interest and depreciation)	153,000
5. LESS: Family living expenses and income taxes	35,000
6. Earnings available for interest and principal payments and new investments	44,000
7. LESS: Interest and principal payments	32,500

8. Remaining earnings available for risk, uncertainty, or new investments	11,500
Earnings coverage ratio = line 8 divided by line 7	35%
Debt payment ratio = line 7 divided by line 3	14%
Operating expense to revenue ratio = line 4 divided by line 1	73%

## Statement of Projected Cash Flow

Projecting cash flow for an agricultural operation gives recognition to the importance of cash flow in servicing the debt of an ongoing operation. It also tends to impose some discipline on both borrower and lender by requiring a thoughtful planning process for the year in terms of anticipated income, expenses, financing needs, debt-servicing requirements, and capital expenditures. For individual or family farm operations, family living expenses should be included in the projections, as well as nonfarm income.

A cash-flow statement typically shows both the timing and amount of cash receipts and expenses. It can be either a forecasting device (statement of projected cash flow) or historical record (statement of actual cash flow). Banks and other lenders most commonly use the statement of projected cash flow because it aids in planning the borrower's credit needs, usually for the coming 12-month period.

A statement of projected cash flow shows not only how much credit is likely to be needed, but approximately when it will be needed. Perhaps most importantly, it shows whether cash income is expected to exceed expenses for the year. It also indicates the likely high point of the credit (amount and time) and the expected cash or debt position at the end of the year. The projected cash-flow statement represents a kind of budget that provides benchmarks against which actual performance can be compared. Significant variances call for explanations and may prompt certain actions to improve future operating results. Historical statements of actual cash flow have value for comparative purposes and can be an excellent aid in preparing projections for the following year, although banks do not typically request them from most agricultural borrowers. They tend to rely, instead, on income tax returns for information on actual operating results.



Cash flow projections are usually made near the beginning of a calendar year, although timing can vary depending on the nature of the operation. The statement is prepared as a spreadsheet normally listing, by month, anticipated cash receipts and disbursements. For each period, the projected operating-loan balance is shown after adjusting for the amount of projected net cash flow.

## AGRICULTURAL LOAN POLICIES

Not all banks make agricultural loans, but for many banks, these loans comprise a significant portion of their portfolios. Any bank making agricultural loans should have developed an adequate, formalized set of written policies to guide the lending officers and staff. Agricultural loan policies should address the same general considerations as the policies used for other loan categories, such as desirable, undesirable, or prohibited loans; collateral requirements (including evaluation guidelines); maximum loan-to-value ratios; maximum maturities; documentation requirements; and concentration limitations. Given the specialized nature of agricultural assets and the varied types of operations, the policies should be comprehensive and specifically address the types of agricultural loans the bank intends to make.

Some banks may have general policies, supplemented by separate procedures or practices. Regardless of the individual bank's terminology or the way in which the material is organized, it is important that the bank's board of directors ensure that appropriate written guidance is provided for management in the agricultural lending area. The policies should help ensure that loans are made on a sound basis and provide a framework for identifying, addressing, and resolving problems that arise. Loan grading, either by the loan officers, a separate loan review function, or both is desirable, as well as a general plan for actions to be taken on loans with unsatisfactory grades. The policies should also address collection and charge-off considerations. Agricultural loan policies should be reviewed by the bank's board of directors and modified when deemed necessary. For more detailed guidance on bank loan policy, refer to section 2040.1, "Loan Portfolio Management."

## AGRICULTURAL LOAN DOCUMENTATION

Loan documentation establishes the bank's legal position as creditor and secured party and evidences the borrower's ownership of and actual existence of collateral. Some documents, such as an insurance policy, give some evidence of collateral values and ensure that tangible collateral is protected. A number of documents play a supporting role, as they provide information that is vital in assessing a borrower's creditworthiness and in demonstrating the borrower's financial capacity to regulatory authorities, auditors, loan reviewers, senior management, and the board of directors. The documents also help management to service and grade the credit, determine the nature and extent of any problems, and formulate plans to resolve them by strengthening the bank's position or averting losses.

Absence of complete and current loan documentation is a weakness in the lending function and can pose a significant threat to the bank's safety and soundness. Some documentation exceptions are noted during virtually every examination, largely due to inadvertent oversights or unavoidable delays in obtaining original or updated documents. However, an unusually large volume of exceptions can be an important indication of weak and deteriorating loan quality. Excessive exceptions reflect unfavorably on management and indicate a need for management to either formulate stronger loan policies and procedures or to emphasize adherence to established guidance.

Many banks use a standard checklist to help ensure that all applicable documents are obtained when a loan is made. Most banks also have either an automated or manual "tickler" system to identify when updated documents are needed, such as current financial statements, tax returns, UCC-1 filings, collateral inspections, and evidence of insurance. Because of the large volume of required documents, many of which need to be updated at least annually, it is imperative that bank management be firmly committed to a sound loan documentation program. The program should establish responsibility for obtaining documents, monitoring compliance, and providing follow-up to help ensure that all required documents are obtained in a timely manner.

Not every document is applicable to each agricultural loan. Examiners need to assess which

documents are appropriate for a given loan depending on its individual circumstances. There should be little disagreement between examiners and bank management about the basic documents needed. Basic documentation requirements are usually listed in the bank's loan policies or procedures. The need for certain supporting documents may be a matter of judgment, particularly in regard to frequency of updating documents. In most cases, however, bankers and examiners tend to agree on items that are to be considered documentation exceptions. Refer to section 2080.1, "Commercial and Industrial Loans," for further guidance on loan documentation. Following is a list of the types of documents a bank should have in connection with agricultural loans:

- promissory note
- security agreement
- financing statement
- real estate mortgage or deed of trust
- other collateral assignments, as appropriate (such as assignments of third-party notes, mortgages or deeds of trust, life insurance policies, deposit accounts, securities, or other contracts)
- subordination agreements (for example, a prior lienholder may subordinate its lien position to a bank to induce the bank to make a loan)
- appraisals
- hazard insurance policy or certificate of coverage
- cash-flow projections, usually prepared annually
- income tax returns
- financial statements (balance sheets) for the borrower, cosigner, or guarantor
- collateral inspection reports by the bank
- bill of sale for livestock or equipment
- worksheet for each note (showing the purpose, timing, and source of repayment; collateral; total existing bank debt; analysis)
- overall credit analysis (particularly on large or troubled loans)
- loan officer memos and comments
- correspondence

## LOAN ADMINISTRATION AND SERVICING

In addition to making agricultural loans, analyzing creditworthiness, setting loan terms, obtain-

ing collateral, and assembling required documentation, management needs to administer the portfolio of outstanding loans. They need to monitor borrowers' performance relative to agreed-upon terms, collateral margins, financial and income data, cash flow, crop prospects, and market trends that may affect borrower performance. If problems arise, bankers need to formulate and implement plans to protect the bank's position.

## Farm and Livestock Inspections

A physical inspection of the farming operation is usually performed by bank management before advancing any substantial funds to a new borrower. Subsequent inspections, particularly for larger or more marginal borrowers and for readily moveable collateral, should be performed periodically. Inspections may be performed by the loan officer or by another bank officer or employee with agricultural experience. The inspector usually prepares a fairly detailed report listing farm assets (livestock, equipment, grain and feed on hand, and growing crops) and at least brief comments on the condition of assets and crop prospects. Often, a listing of machinery, equipment, and vehicles is prepared from the bank's records ahead of time to aid in the inspection process; any additions, deletions, or exceptions noted should be shown on the report. Livestock are listed by type, showing numbers, sex, and approximate weight. Values for all items should be shown on the report, based on current market prices. The report may note the number of acres the potential borrower owns and rents, as well as the approximate value of real estate owned. A real estate evaluation might be performed as part of a farm inspection, but a full appraisal, if required, would almost always be performed separately, usually by another individual.

Farm inspections are usually performed annually, unless the borrower has a livestock feeding operation or some other type of operation that involves frequent turnover of assets. Generally, it is desirable to inspect feeder operations approximately every six months or more frequently if deemed necessary. The absence of a current inspection report, especially for larger or troubled borrowers, may be considered a loan-documentation exception.

## UNSOUND AGRICULTURAL LENDING PRACTICES

Following is a list of common unsound lending practices, some of which are general and apply to all types of loans while others relate more specifically to agricultural loans. This list includes the most common shortcomings. Depending on the extent of the unsound practices, the examiner should incorporate specific recommendations for improvement into the examination report or formal supervisory action where appropriate.

- absence of or failure to follow sound lending policies and procedures
- failure to require adequate performance on debt
- failure to monitor the borrower's performance and position, commonly evidenced by the—
  - lack of periodic collateral inspections
  - absence of current income and financial information
  - failure to consider the borrower's total debt-service requirements
  - presence of additional operating debt at another bank; or
  - absence of a lien search to verify the bank's position in collateral
- inappropriate loan structuring, such as—
  - untimely or inappropriate repayment schedules
  - failure to identify or segregate carryover operating debt
- unwillingness to say “no” to a financially stressed borrower, which could be an indication of—
  - overlending (building loan volume without regard to quality or long-term effects on the borrower and the bank)
  - failure to consider borrower's management capabilities
  - failure to analyze or project costs of production
  - failure to observe market trends.
- lending for speculative purposes
- lending outside of the bank's normal trade area
- lending on new or unproven types of operations or operations in which bank management has little or no experience

## TROUBLED AGRICULTURAL LOANS

Aside from readily identifiable problem loans such as past-due loans, loans on nonaccrual status, loans on the bank's watch list or those that were previously classified, or loans to borrowers who have filed for bankruptcy, the following characteristics may indicate existing or potential problems. Examiners should keep in mind both current conditions and trends.

- undermargined collateral position
- unusually high leverage
- marginal liquidity
- heavy investment in equipment, vehicles, or real estate
- need for unplanned credit advances
- deficiencies or problems revealed in the collateral inspection
- unfavorable financial trends (especially increasing debt-to-worth ratio or declining collateral margins)
- lack of performance (renewals without appropriate performance)
- capitalizing interest on debt
- charge-offs
- inability to meet scheduled debt payments
- tax problems
- reluctance of borrower to provide current, complete, and accurate financial information
- notification of insurance cancellation for failure to pay premium
- evidence of legal action against the borrower
- overdependence on guarantors
- overdependence on anticipated inheritance

## CHAPTER 12 BANKRUPTCY

Chapter 12 bankruptcy for family farmers became effective in November 1986. It was designed specifically for the family-farm debtor and permits family farmers to reorganize farm debt so that the amount of the debt approximates the value of the collateral. Only a “family farmer with regular annual income” (which can be a partnership or corporate structure) may file a chapter 12 bankruptcy. To be eligible, a debtor must meet *all* of the following tests:

- have a farming operation
- have no more than \$1.5 million in total debts
- derive at least 80 percent of total debts (exclud-

ing debt on the principal residence) from the farming operation

- derive more than 50 percent of the family's income from the farming operation during the year immediately preceding the filing

The family farmer will have regular annual income if the court finds the annual income to be sufficiently stable and regular to enable the farmer to make payments under the chapter 12 plan.

Under chapter 12, there is no requirement for accelerated payment of arrearage as there is with chapter 13. Instead, the farmer/debtor can commence making plan-required payments from the start of the chapter 12 bankruptcy. Also, a farmer/debtor will have the ability to modify a promissory note and continue payments on it beyond the life of the chapter 12 plan if the court approves the modification; in such cases, the creditor cannot object.

A secured creditor will be "adequately protected" during the chapter 12 bankruptcy if it receives cash payments to offset any decrease in the value of collateral and, in the case of farmland, if the creditor is paid a reasonable rental fee based on the earning capacity of the property. Also, chapter 12 does not allow the creditor to recover "lost opportunity costs," so the creditor will not be entitled to interest and other gains that would have been received by the creditor had bankruptcy not been filed. Elimination of the lost-opportunity-cost provision makes it more difficult for creditors to obtain a lift of stay on the grounds that there is not adequate protection.

Before confirming the chapter 12 plan, a court may permit a farmer to sell pledged assets without the consent of the secured creditor, although proceeds from the sale must go to the secured creditor. Creditors may bid at the sale, and collateral that is not sold will be subject to current evaluation in determining what amounts will be claimed by secured creditors under the plan. There is no time limit on the duration of a chapter 12 plan, except for a three-year limit (or five years with court approval) on unsecured debts.

If a chapter 12 debtor voluntarily dismisses the case, he is prohibited from refile for 180 days. The law also provides for a dismissal from chapter 12, or a conversion to chapter 7, when the debtor commits fraud. Any other provisions of chapter 12 that are not discussed

here are generally similar to those in chapter 11 and chapter 13 bankruptcy proceedings.

## WORKING OUT PROBLEM AGRICULTURAL LOANS

When significant problems arise in agricultural credits, bank management resolves the problems in a timely manner to protect and strengthen the bank's condition. A sound and accurate loan-grading system, supported by a competent internal loan review program, will help to ensure timely identification of problems. Regulatory examinations provide an independent assessment, which may identify additional problems that management has not recognized. Once problems are identified, the following considerations are important in a workout program:

- identify the source of the problem
- establish a workout plan designed to strengthen the borrower and to minimize loss to the bank
- set at least a tentative timetable for the workout
- reach agreement with the borrower on the plan, if possible
- monitor progress frequently

Alternative actions in a workout plan might include—

- reducing the bank's exposure in outstanding debt by—
  - obtaining additional collateral,
  - obtaining financial assistance through sound cosigners, guarantors, or government guarantees,
  - encouraging the borrower to modify his operations, or
  - restructuring the credit to reduce the interest rate or payments
- advancing more funds to—
  - refinance existing nonbank debt on more favorable terms or
  - improve the bank's overall collateral position (for example, take out a small balance to a senior lender to put the bank in a first lien position)
- reducing or eliminating outstanding bank debt by—
  - selling assets, which can range from a partial sale to reduce debt burden and improve chances for survival to a complete liquidation;

- refinancing a portion of bank debt (such as real estate) elsewhere if more favorable rates or terms are available; or
- recognizing a loss by partial or complete charge-off of the credit.

## EXAMINER REVIEW OF AGRICULTURAL LOANS

A review of agricultural loans during an examination will follow the same basic guidelines employed in reviewing commercial or real estate loans. Certain practices, types of collateral, and documents may be unique to agricultural loans, and credit analysis will be somewhat specialized. However, the objectives of assessing credit quality based on the borrower's financial strength,

cash flow, collateral, history of performance, and indications of management capabilities are much the same as for other loan types.

Sample size and sampling techniques will vary with the planned scope of the examination and size of the bank and its agricultural loan portfolio. As a minimum, the examination scope would usually include past-due and nonaccrual loans, watch-list loans, previously classified loans, insider loans, and some portion of other loans. See section 2080.1, "Commercial Loans," for details regarding this topic.

Classification of agricultural loans should be made using the same criteria established for other types of loans. See section 2060.1, "Classification of Credits," for regulatory definitions of substandard, doubtful, and loss classifications, as well as the special mention category and guidance on classifying loans.

# Agricultural Loans

## Examination Objectives

Effective date May 1996

## Section 2140.2

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1. To determine if lending policies, practices, procedures, and internal controls for agricultural loans are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the agricultural loan portfolio for credit quality, performance, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

This section reinforces key factors in agricultural lending and provides a discussion of potential agricultural market issues and risk ramifications banking organizations and supervisory staff should consider when assessing the adequacy of the risk-management practices and capital needs for a bank's exposure to agriculture-related risks. This supervisory guidance also addresses factors that examiners should consider in evaluating individual agriculture-related credits and the adequacy of a banking organization's practices to monitor a borrower's capacity to repay given uncertain events. These concepts are based on the existing guidance within this manual's section 2140.1, "Agricultural Loans."

A bank's risk-management and capital planning practices should be sufficiently robust to assess the level of agriculture-related credit risk and the adequacy of a bank's capital to withstand potential future market and economic distress. The risk-management principles discussed in this section are broadly applicable, irrespective of agricultural market conditions.

### MARKET ISSUES AND RISK RAMIFICATIONS

Prolonged and abrupt declines in farm income, brought about by negative movements in commodity prices and/or increased production costs, could have serious ramifications for the repayment ability of previously sound farm borrowers and could result in substantial declines in farmland collateral values. Highly leveraged farm borrowers or those that are in weakened financial condition would be most vulnerable to abrupt or prolonged financial distress.

Banks should monitor a number of market factors in order to manage and control the risk of their agriculture-related loan portfolio (including collateral values for farmland) and determine the repayment ability of individual farm borrowers. These factors include the following:

- *Agricultural commodity prices.* These prices have experienced unusually large swings over the past several years.
- *Production costs.* Volatility in costs for labor, feed, fertilizer, seed, land rent, and machinery and equipment may challenge farm opera-

tors' ability to effectively manage operating profit margins.

- *Farmland values.* Land values, particularly in the central United States, have surged to record highs over the past several years. Capitalization rates for farmland, particularly cropland, appear to be well below historical norms and may reflect overly optimistic long-term expectations. An abrupt increase in interest rates, coupled with a decline in farm income, could trigger an increase in capitalization rates, thereby lowering farmland values.
- *Global market issues.* Global supply and demand imbalances can adversely affect commodity prices and the cost of production. For example, weather events, economic conditions, and numerous other factors can impact global supply as well as demand and place downward pressure on farm income. Producers of ethanol and other biofuels may be adversely affected by the volatility in oil, corn, and other commodity prices.

### SUPERVISORY EXPECTATIONS FOR CREDIT-RISK MANAGEMENT AND UNDERWRITING PRACTICES

The potential for volatile market conditions and risk factors raises the importance of ensuring that agricultural banks have in place appropriate risk-management programs and prudent lending standards. A key component of a sound risk-management program is the linkage between an analysis of market conditions and an agricultural bank's risk-management and capital planning practices. The range and extent of market analysis may vary depending on the composition of the bank's portfolio and overall risk exposure. The goal of this analysis should be to provide management and the board of directors with sufficient information on current market conditions, factors that could influence changes to market conditions, and possible events that could significantly change near- and long-term market conditions. At a minimum, banks with significant agricultural exposure should have established risk-management practices that address the following:

- *Assessment of the Borrower's Creditworthiness.* A bank should conduct a thorough

analysis of a borrower's creditworthiness, including assessments of the borrower's projected income and expenses compared to actual results, adequacy of working capital, capital expense analysis, reliability of supplementary sources of income, and cash flow stress test analysis. Current borrower financial information is essential to the bank's ability to evaluate the borrower's creditworthiness and leverage. A successful agriculture-related business should exhibit strong repayment ability and risk analysis, liquidity, solvency, collateral, credit management, profitability, and management performance.

- *Assessment of the Borrower's Cash Flow.* In volatile markets, a highly leveraged borrower may not have the necessary cash flow to properly service the debt according to the loan terms. By reviewing the borrower-prepared cash flow statements, the bank should be able to identify potential repayment ability problems, calculate key cash flow ratios, and assess the ability of the business to handle risk and uncertainty. Risk and uncertainty due to commodity prices, production, and weather are prevalent characteristics of most farm operations and should be explained in the cash flow projections. A sensitivity analysis that determines a farm operation's ability to withstand risk and uncertainty is useful in analyzing cash flow projections. While there is a broad spectrum of agricultural activities (e.g., grain, livestock, and fruit), there are some key elements of sound financial analysis that should be applied to all situations. These elements include
  - reviewing the reasonableness of budget assumptions and projections for yield, weight gain, production costs, and commodity prices;
  - comparing these projections with actual performance results;
  - assessing the impact of capital expenditures; and
  - evaluating significant changes in the borrower's balance sheet structure.
- *Underwriting Standards.* A bank should periodically review its underwriting standards to ensure that loan policies do not become outdated and ineffective. The frequency and depth of the review will depend on circumstances specific to each institution, such as growth expectations, competitive factors, economic conditions, and the bank's overall financial condition. Planned changes to a bank's lending function or business plan should prompt a modification to lending policies. The appropriateness of minimum debt-service-coverage ratios and maximum loan-to-value ratios should be assessed. Significant criticisms and recommendations made during recent audits and examinations should also be considered during the updating process.
- *Credit Administration and Controls.* A bank should have appropriate policies and controls to monitor and segregate agricultural carryover debt. Bank management should understand the fundamental causes of carryover debt. Carryover debt resulting from the borrower's inability to generate sufficient cash flow from sales to repay the current cycle's production loans generally reflects a well-defined credit weakness. The identification of a troubled borrower does not, however, prohibit a banker from working with the borrower. When carryover debt arises, the bank should confirm the reasons for the carryover debt (e.g., weaknesses in a borrower's financial condition or operations, inappropriate credit administration on the bank's part, a poor marketing plan, or adverse weather conditions), as well as the viability of the borrower's operation so that an informed decision can be made on whether debt restructuring is appropriate. The restructured debt should generally be on a term basis and require clearly identified collateral, a reasonable amortization period, and payment amounts based on realistic expectations.
- *Loan Structure.* The structure of a loan will depend on the nature of the borrower's business. To properly structure the borrowing relationship, the bank should be able to
  - project how the borrower will perform in the future, including likely primary and secondary repayment sources;
  - anticipate challenges and problems that the borrower may encounter;
  - match the type and terms of the loan to both the loan purpose and the likely repayment sources and ensure the loan is supported by sufficient cash flow from the expected repayment source;
  - develop a set of loan agreement covenants that protects the bank for the term of the loan; and
  - secure the credit facility with collateral and consider requiring loan support such as guarantees.
- *Reliable Collateral Evaluations and Reason-*



*able Collateral Margins.* A bank should have a process in place to monitor periodically the value of collateral pledged to the debt in order to manage the risk over the life of the loan. Evidence of collateral lien perfection and timely collateral inspections should be documented in the loan file review. Evidence of declining collateral margins may signify emerging concerns over the ability of the borrower to repay and could adversely affect the bank's collateral protection in the event of default.

Expectations for the level of sophistication of risk-management systems will vary based on the specific risk characteristics, complexity, and size

of the bank's exposure to agriculture. In general, there should be higher expectations around risk-management systems for banks with significant exposures to one or several agricultural sectors. An institution should assess the effect, if any, of its agricultural credit activities upon the institution's overall financial condition, including capital, the allowance for loan and lease losses, and liquidity.<sup>1</sup>

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1. See, respectively, SR-09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies"; SR-06-17, "Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)," (section 2070.1); and SR-10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management," (section 4020.1).

### INTRODUCTION

This section is intended to provide guidance to examiners reviewing small, noncomplex production loans, usually to small independent oil and/or gas operators. The examination of a loan to a small oil or gas operator is considerably different from the examination of most commercial loans, and is similar in some respects to examinations of real estate loans. The only asset that many small independent operators have is oil or gas in the ground or both. Loans to operators are based solely on the predicted cash-flow value of the oil or gas production. Therefore, a production loan is a loan secured by interests in oil and/or gas production properties. Cash flow generated from the future sale of encumbered oil and/or gas reserves is the primary, and in some cases, the only credible source of repayment. Therefore, production payments are usually assigned to the bank, and the liquidation value of collateral is expected to be sufficient to pay off the loan at any time. In considering this or any type of secured loan, the banker will determine or judge the character, capacity, credit history, and other credit factors related to the borrower. Also, the bank must determine that the operator of the properties is capable and dependable.

Because cash flow generated from the future sale of oil or gas is the justification or basis for production lending, only proved-producing reserves are acceptable collateral for a bank because they provide sufficiently predictable cash flow for debt service. For this reason, loan values are predicated primarily on reserves that are proved-developed-producing properties.

### DEFINITIONS OF RESERVES

Reserves are classified into one of three categories: proved, probable, or possible, with proved divided into three subcategories.

#### Proved Reserves

- *Proved-developed-producing.* These wells have been drilled and completed, and are producing oil or gas.

- *Proved-developed-nonproducing.* These are generally proved-developed reserves behind the casing of existing wells or at minor depths below the present bottom of such wells that are expected to be produced through these wells in the predictable future. The development cost of this type of reserves should be relatively small compared with the cost of a new well.
- *Proved-undeveloped.* These are reserves that are proved resources to be recovered from new wells on undrilled acreage or from existing wells requiring a relatively major expenditure for recompletion.

#### Probable Reserves

- *Probable reserves.* These reserves might include those expected to be producing from existing or planned wells in areas anticipated to be economically beneficial, based on geological or seismic data.

#### Possible Reserves

- *Possible reserves.* These reserves include those whose existence may be inferred from geological considerations, including potential reserves from planned waterfloods or other recovery techniques that have not been proved.

### EVALUATION OF RESERVES

When a lender decides to proceed with financing secured by oil or gas reserves, an engineering report will be obtained. The initial step to determining the loan value of the collateral or assessing the creditworthiness of a production loan is an analysis of the engineering report. Banks that make production loans will usually have a petroleum engineer on staff or contract with an engineering consultant firm to provide an engineer's report on the properties to be pledged. Basically, the engineering report consists of determining reserves and production forecasts and then applying the pricing and costs to arrive at the net lease operating income available for debt service. This report is comparable to a real estate appraisal in its importance and function.

The following table is a very simple presentation compared with the typical evaluation of oil and gas properties in an engineer's report. Typically, most reports will detail five or more years with the last row including all remaining years. Production is usually broken down into categories of oil and gas, and sometimes the number of wells is detailed. Expenses may be divided into major components such as operating costs; production and ad valorem taxes; depreciation, depletion, and write-off of intangibles; general and administration expenses; and taxes on income. Also, if the owner expects to make capital improvements from income, a column may be added for that factor. Some reports include the pro forma amount and terms of the loan to aid the analysis.

Engineering reports must be generated by a fully qualified petroleum engineer. The lender must have complete confidence in the engineer's ability and intellectual honesty, as well as in the quality of the data and its susceptibility to analysis. The integrity of engineering data that depict future cash stream is critical to the initial lending decision and equally important to an examiner in the assessment of credit quality. In summary, an acceptable engineering report must be an independent, detailed analysis of the reserves prepared by a competent engineer. The examiner should carefully review the following three elements.

## Pricing

The value assigned to production and expenses must be realistic. Operating costs are based on what similar operations in similar areas have been or, in the case of producing reserves, on historical performance, which may be escalated at some reasonable percentage each year. The report should consider increases and decreases in price as well as cost inflation over the "life of the properties." The future price of oil is a judgment factor and should be based on conservative pricing and can include some reasonable escalation each year. This information can be obtained from a number of reliable sources, and the examiner should determine the source to judge the reliability of report information. The prices used for gas are usually contract prices plus escalation-clause rates. Special care is necessary in evaluating gas contracts, including their reasonableness in light of current conditions and the ability and willingness of the purchasers to honor the contracts. In some instances, certain purchasers have broken contracts or exercised "market-out" clauses to cease complying with long-term purchase commitments. The Securities and Exchange Commission requires reserves with renegotiable contracts or under market-out clauses to value the reserves at spot prices at the date of renegotiation or immediately, in the case of market-out clauses.

TABLE 1  
ENGINEER'S REPORT—EVALUATION OF OIL AND GAS PROPERTIES

<i>Year</i>	<i>Production \$18 per Barrel (bbl)</i>	<i>Future Income</i>	<i>Operating and Other Expenses</i>	<i>Future Net Income</i>	<i>Present Worth (PW) Future Income @10%</i>	<i>PW Future Net Income @10%</i>
1	5,000	\$ 90,000	\$10,000	\$ 80,000	\$ 85,800 <sup>1</sup>	\$ 76,300
2	4,000	72,000	8,000	64,000	62,400	55,500
3	3,000	54,000	7,000	47,000	42,600	37,000
4	2,000	36,000	6,000	30,000	25,800	21,500
5	1,000	18,000	5,000	13,000	11,700	8,500
Total	15,000	\$270,000	\$36,000	\$234,000	\$228,300	\$198,800

1. For present-worth calculations, usually ½ year is used for the first period, 1½ for the second period, and 2½ for the third period, and so on.

## Present Worth

Present worth is used to recast future income into the equivalent dollar value today; it should reflect current market interest rates. The present worth of future net revenues is used to help determine the maximum amount that can be loaned.

## Timing

Preferably, the report should be no more than six months old. A report that is up to 12 months old may be acceptable in some cases; however, it should not be more than 12 months old. Change is the most important factor in determining the adequacy and timeliness of reports. Recent significant price fluctuations or changes in interest rates may require the examiner to adjust the valuation of the reserves to reflect current conditions.

The engineer is responsible for ensuring that the evaluation includes only proved-developed-producing reserves, unless otherwise directed by the lender. In some cases, the lender might give value to a property or well that is proved-developed-nonproducing if it has been drilled and completed, but is not producing because sales facilities or a gas pipeline hookup has not been completed. The lender would, however, deduct a safety factor by cutting back the reserves assumed to be dedicated to that well because the margin of error increases. However, the lender will not generally loan against proved-undeveloped, probable, or possible reserves because of the speculative nature of those categories. Their inclusion as collateral is usually as an abundance of caution with little or no value assigned to them.

A judgment has to be made on the probable accuracy of predictions of future revenues. The engineer evaluates geologic conditions such as sand continuity, faulting, spacing, the number of wells, the diversity of properties, well productivity, the pressure production history, and overall data quality, as well as the degree of confidence the engineers have in their own numbers. Estimates based on well-established production performance are given the most credibility. Lesser weight is given to estimates derived from more speculative methods such as volumetrics, analogy with similar reservoirs, or a computer simulation of new producing zones. The examiner should carefully review the narrative por-

tion of the engineer's report to help determine its usefulness. It will detail what data were available, how they were used, the methods of analysis, and whether a field inspection was made, including individual well tests. This section of the report should inform the examiner of the true condition of the well and reserves. It is possible for the projected cash flow to portray one picture while the narrative portrays an entirely different one.

Generally, a bank will loan up to 50 percent of the net present value of proved-developed-producing reserves; however, a lower percentage may be needed depending on a number of factors. If the reserves are in an area that is highly faulted, or if seismic work and drilling indicated that a zone is contiguous from one well to the next and the porosity and permeability of the pay-zone rock are very similar, then a smaller percentage will be used. To avoid the possibility that any individual, unforeseen event will have a significant effect on the total projection, a wide spread of properties is preferable. This applies not only to a concentration of value in any one well, but also to a concentration in one reservoir, field, or producing area. Generally, a safety factor of not less than 2:1 will be used on proved-producing properties, but on long-life and high-quality reserves, a safety factor of 1.5:1 is sometimes used. However, wells that are highly faulted may require a 3:1 or higher safety factor. Terms will usually require that the loan be fully repaid before the safety factor is reduced.

## DOCUMENTATION

The documentation for a term loan is relatively simple. There is a note, a loan agreement, a deed of trust/mortgage, an assignment of production (usually in the mortgage), a title opinion, and a security agreement/financing statement. The assignment of oil and gas interests is unique because oil and gas are treated as real property while in the ground but convert to personal property interests as production is generated at the wellhead. Most lenders also require an affidavit as to payment of bills. Also, the owner or the operator is usually required to guarantee payment of the loan.

The bank will obtain an acceptable title opinion that indicates the borrower has, on the date of the loan, clear title to each of the leases under mortgage and that properties are free and clear

of all liens. After the loan is closed, the bank will send a letter of instruction to notify the company sending out production checks that the bank has taken a lien on the production and to request that production checks be sent directly to the bank. The mortgage covers surface rights and mineral interests. A copy of the mortgage containing an assignment of production will be sent to the company purchasing the production, along with a request that division orders or transfer orders be prepared recording its interest in production payments. This authorizes the purchaser to send production payments directly to the bank for the account of the borrower. The security agreement and financing statement covers removable equipment, oil and gas inventory above the ground, and accounts receivable. The financing statements are filed in the real estate records of the county in which the properties are located (usually with the county clerk) and in the secretary of state's office. This filing is done to perfect security interests in equipment, which may be moved from place to place. However, some states have different requirements, and the examiner should be familiar with each state's filing requirements. The affidavit as to payment of bills is executed by the borrower to ensure that all the bills have been paid on the properties or will be paid out of loan proceeds. If bills are to be paid out of proceeds, the bank should ensure that payments are verified. The loan agreement should be read very carefully by the examiner with close attention paid to both positive and negative covenants.

The bank will usually take a collateral interest in equipment, accounts receivables, and inventory. The deed of trust/mortgage will cover real estate, surface rights, and mineral interests, and a security agreement will cover removable equipment, oil as inventory (in tanks), and accounts receivable. An appropriate filing is needed for each type of collateral. Filing requirements may vary from state to state and should be researched. Generally, collateral documents should be filed with the state and county. It is reasonable to expect the bank to have collateral files completed within two to three months.

## CLASSIFICATION GUIDELINES FOR TROUBLED PRODUCTION LOANS

The classification of production loans is like all loan classifications in that it must be predicated

on an independent assessment of all credit factors that are germane to the specific credit being reviewed. A comprehensive analysis of the credit must take place if any of the following factors are present:

- The loan balance exceeds 65 percent of the discounted present worth of future net income (PWFNI) of proved-developed-producing reserves, or the cash-flow analysis indicates that the loan will not amortize over four to five years.
- The credit is not performing in accordance with terms or payment of interest and/or principal.
- The credit is identified by the bank as a problem credit.
- Other factors indicate a potential problem credit.

After performing the analysis, the examiner must determine if classification is warranted. When classification is warranted, the following guidelines are to be applied when repayment of the debt is solely dependent on oil and/or gas properties pledged as collateral. A lesser percentage or less severe criticism may be appropriate when other reliable means of repayment exist for a portion of the debt.

### Proved-Developed-Producing Reserves

Sixty-five percent of discounted PWFNI should be classified substandard when the discounted PWFNI is determined using historical production data (decline-curve-analysis engineering). When less than 75 percent of the reserve estimate is determined using historical production data, or when the discounted PWFNI is predicated on engineering estimates of the volume of oil/gas flow (volumetric and/or analogy-based engineering data), the collateral value assigned to substandard should be reduced accordingly. The balance, but not more than 100 percent of discounted PWFNI of proved-developed-producing (PDP) reserves, should be extended doubtful. Any remaining deficiency balance should be classified loss.

### Other Reserves

In addition to PDP, many reserve-based credits will include proved-developed-nonproducing

reserves, shut-in reserves, behind-the-pipe reserves, and proved-undeveloped properties (PUPs) as collateral. Due to the nature of these other reserves, there are no strict percentage guidelines for the proportion of the credit supported by this type of collateral that should remain as a bankable asset. However, only in very unusual situations would the proportion of collateral values assigned to a classification category approach the values for PDP. The examiner must ascertain the current status of each reserve and develop an appropriate amount. Examples could be reserves that are shut in due to economic conditions versus reserves that are shut in due to the absence of pipeline or transportation. PUPs require careful evaluation before allowing any bankable collateral value. An example of a bankable value for a PUP could be one that has a binding purchase contract. In every classification where a bankable value is given for any of these other reserves, the loan write-up should fully support the examiner's determination.

The above guidelines apply to production loans that are considered collateral-dependent and are devoid of repayment capacity from any other tangible source. Rarely should bankable consideration be given to loans that are completely collateral dependent in excess of the liquidation value of the pledged reserves. Once again, there is no substitute for a specific, case-by-case analysis of applicable credit and collateral factors pertaining to each individual credit. Frequently, when a lender encounters problems with a production credit, numerous other types of assets (for example A/R, inventories, or real estate) are encumbered in an effort to protect the bank's interests. Other types of

collateral and sources of repayment should be carefully evaluated on a case-by-case basis.

## SAMPLE CASE

The following case describes some of the general principles related to production lending. A customer applied for a \$100,000 loan to help fund the purchase of oil reserves, which will be used to secure the note. Based on an analysis, the loan officer agreed to make a loan and secure it with oil production. As part of the analysis, the loan officer ordered an engineer's report on the properties to determine the half-life of the cash flow—the point at which 50 percent of cash flow available for debt service has been depleted. Using table 1 (presented earlier in the "Evaluation of Reserves" subsection), the loan officer determined that cumulative PWFNI equals \$198,800 and 50 percent of that amount equals \$99,400. In the next step, the loan officer determined the point in time that \$99,400 is reached, which in this case is 17 months. Based on these calculations, the loan officer determined that the maximum loan should not exceed \$99,400 and should be repaid within 17 months. He offered a term loan to the borrower for \$99,400 with 17 monthly payments of \$5,847 principal plus interest of 12 percent. Although the loan request was for \$100,000, the borrower accepted the offer. Shortly after the loan is made, the value of oil declines from \$18 bbl to \$12 bbl, and the discount used for evaluations increases from 10 to 15 percent. As a result, table 1 was revised. Table 2 includes these new factors.

TABLE 2  
ENGINEER'S REPORT—EVALUATION OF OIL AND GAS PROPERTIES

<i>Year</i>	<i>Production @\$12 bbl</i>	<i>Future Income</i>	<i>Operating and Other Expenses</i>	<i>Future Net Income</i>	<i>PW Future Income @15%</i>	<i>PW Future Net Income @15%</i>
1	5,000	\$ 60,000	\$10,000	\$ 50,000	\$ 56,000	\$ 46,600
2	4,000	48,000	8,000	40,000	38,900	32,400
3	3,000	36,000	7,000	29,000	25,400	20,400
4	2,000	24,000	6,000	18,000	14,700	11,000
5	1,000	12,000	5,000	7,000	6,400	3,700
Total	15,000	\$180,000	\$36,000	\$144,000	\$141,400	\$114,100

The loan now exceeds 65 percent of PWFNI of PDP reserves, and a comprehensive analysis of the credit is performed. Because the obligor is devoid of other repayment capacity or other reliable means of repayment, with total support of the debt provided solely by the pledged production, the loan should be classified. Sixty-five percent of discounted PWFNI of PDP reserves equals \$74,165, and this amount will be classified substandard. The balance of \$16,827, which is also supported by discounted PWFNI of PDP reserves, should be classified doubtful. The loan should be placed on nonaccrual status with any outstanding interest classified as loss.

## TERMINOLOGY

The following are abbreviated explanations or discussions of some of the terms found in engineering reports and energy-lending transactions.

*Analogy-based engineering data.* Comparative analyses relating past performances of comparable properties to determine possible future reserves.

*Assignment of production.* Usually in the mortgage agreement, it allows direct payment from purchaser to the bank for oil production. Gas purchases generally are paid to the operator, and the operator then pays the bank.

*Carried interest.* When a party or parties have their expenses paid (carried) by other parties up to a specified limit.

*Decline curves.* Used to determine reserves by extrapolation of historical production data.

*Deed of trust/mortgage.* Covers real estate, surface rights, and mineral interests. Mortgage is unique because oil and gas are treated as real property while in the ground but converted to personal property interests as production is generated at the wellhead and as oil and gas enter storage tanks or a pipeline. The security agreement portion of the oil and gas mortgage will usually cover fixtures and equipment affixed to the well site.

*Development wells.* Drilled in the proven territory of a field, they have a high likelihood of producing oil or gas.

*Division orders.* Set out the borrower's interest in the property and direct production payments. Division order title opinions can be used to verify ownership and will contain the legal description of properties.

*Escalating.* Involves the difficult task of predicting future prices of oil and gas for valuing production. Escalating the value of production usually increases the risk to the lender. Examiners should carefully review the basis for escalating values when it has a significant impact on the value of the collateral and/or cash flow. Also, the examiner should carefully review how future expenses related to each well are estimated.

*Exploratory well.* Also known as a "wildcat," a well drilled in an unproven area. The term originated in early drilling days in Pennsylvania when wells were drilled within the sight and sound of wildcats.

*Fault.* A break or fracture in the earth's crust that causes rock layers to shift.

*Field.* An area in which a number of wells produce from a reservoir or from several reservoirs at various depths.

*Formation.* A bed or deposit of substantially the same kinds of rocks.

*Fracturing, frac'ing, frac job.* Refers to pumping fluids under extremely high pressure into a formation to create or enlarge fractures through which oil or gas can move. Propping agents such as sand are sent down with fluids to hold the fractures open. Many completed wells require additional treatment (stimulation) before oil or gas can be produced.

*Lease.* A contract between the landowner (lessor) and the lessee that gives the lessee the right to exploit the premises for minerals or other products and to use the surface as needed. However, surface damages would normally have to be reimbursed. Surface ownership is different from mineral ownership in many cases. Also, if drilling does not begin during a specified time period, the lease will expire.

*Lithology.* The scientific study of rocks.

*Log(s).* Used to record three basic measure-

ments: electrical, radioactive, and sonic. The logging device is lowered into the well bore and transmits signals to the surface. These are recorded on film and used to make a log showing the recorded measurements that are used to analyze the formation's porosity, fluid saturation, and lithology. The log's header gives the log's type and date, the operator, the well name, and other information.

*Market-out.* A clause that basically allows the purchaser to stop paying the original contract price and institute a lower price with the intent of maintaining the marketability of the gas. Some contracts allow the producer to be released from the contract if he refuses the lower price or may offer other remedies.

*Mineral rights.* The ownership of minerals under a tract, which includes the right to explore, drill, and produce such minerals, or assign such rights in the form of a lease to another party. Mineral-rights ownership may or may not be severed from land-surface ownership, depending on state law. Title in fee simple means all rights are held by one owner; the fee in surface owner does not hold mineral rights. The term "minerals" is loosely used to refer to mineral ownership and even, incorrectly, to royalty ownership. A mineral acre is the full mineral interest under one acre of land.

*Operator.* The manager of drilling and production for the owner.

*Perforations.* The holes in casing and cement through which oil and/or gas flow from formation into wellbore and up to surface.

*Permeability.* A measure of how easily fluids may flow through pore spaces. A tight rock or sand formation will have low permeability and, thus, low capacity to produce oil or gas. Wells in these zones usually require fracturing or other stimulation.

*Porosity.* Refers to the pore space in rock that enables it to hold fluids.

*Reservoir or pool.* A single accumulation of oil or gas trapped in a rock body.

*Reserves.* The estimated amount of oil and gas in a given reservoir that is capable of being

profitably recovered, assuming current costs, prices, and technology. Not to be confused with oil and gas in place, which is the total amount of petroleum in the earth regardless of whether or not it can be recovered. Recovery is a function not only of technology, but of the marketplace.

*Reserve interest.* The term used to describe the percent of revenue received.

*Royalty interest.* The share of gross production proceeds from a property received by its mineral owner(s), free of exploration, drilling, and production costs. Typically one-eighth to one-sixth of production, but fractions may be higher. Royalty payments take precedence over all other payments from lease revenues.

*Primary, secondary, and tertiary recovery.* Relates to the method of obtaining production from a well. Primary recovery is production from a reservoir through flowing or pumping wells because of the existence of natural energy within the reservoir. This usually recovers about 10 to 35 percent of the oil and gas in place. Secondary recovery is any method by which essentially depleted reservoir energy is restored. This may be accomplished by injection of liquids or gases or both. Tertiary recovery is any enhanced method employed after secondary recovery and is generally very costly.

*Runs.* A term used to refer to oil or gas production income from a lease.

*Seismic survey or shooting.* A method of gathering information by recording and analyzing shock waves artificially produced and reflected from subsurface rocks.

*Stripper wells.* Wells that make less than 10 barrels of oil per day based on the last 12 months or wells that make less than 60,000 cubic feet of gas per day based on the last 90 days.

*Volumetric calculations.* Determine oil or gas reserves by use of rock volume and characteristics.

*Working interest.* Also referred to as an operating interest, the term used to describe the lease owner's interest in the well. Lease owners are the ones who pay for drilling and completing the



well. Lease owners pay 100 percent of cost and receive all revenues after taxes and royalties are paid.

*Workover:* Relates to the process of cleaning out or other work on a well to restore or increase its production.

# Energy Lending—Production Loans

## Examination Objectives

Effective date May 1996

## Section 2150.2

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1. To determine if policies, practices, procedures, and internal controls for energy loans are adequate to identify and manage the risks the bank is exposed to.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the portfolio for performance, credit quality, collateral sufficiency, and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

### INTRODUCTION

Asset-based lending is a specialized area of commercial bank lending in which borrowers assign their interests in certain accounts receivable and inventory, and in selected cases fixed assets, to the lender as collateral. In asset-based lending, the primary repayment source is the conversion of the pledged assets into cash. Asset-based lending differs from a commercial loan in which the bank takes a security interest in all accounts receivable and inventory owned or acquired by the borrower. This section will discuss asset-based lending in relation to the characteristics of the borrower, its advantages to the borrower and the bank, credit and collateral analysis, documentation, and safeguards to ensure the authenticity and collectibility of the assigned receivables.

The examiner must judge the quality of the asset-based credit by evaluating the financial condition and debt-servicing ability of the borrower and the quality of the collateral. In addition, the examiner must evaluate the bank's credit policy, internal controls, audit procedures, and operational practices.

Many borrowers whose financial condition is not strong enough to allow them to qualify for regular, secured commercial bank loans may use asset-based loans to meet their financial needs. Some examples of asset-based borrowers are—

- businesses that are growing rapidly and need year-round financing in amounts too large to justify commercial lines of credit secured by blanket liens on accounts receivable and inventory,
- businesses that are nonseasonal and need year-round financing because working capital and profits are insufficient to permit periodic cleanups,
- businesses whose working capital is inadequate for their volume of sales and type of operation, and
- businesses that cannot obtain regular commercial loan terms because of deteriorating credit factors.

Some advantages of asset-based lending for the borrower are—

- efficiency in financing an expanding operation because the business's borrowing capacity

expands along with increases in levels of accounts receivables, inventory, and sales;

- the ability to take advantage of purchase discounts because the company receives immediate cash on its sales and is able to pay trade creditors in a timely manner (consistent usage of purchase discounts reduces the cost of goods sold and enhances the gross profit margin); and
- the interest paid on asset-based loans may be lower than for alternate sources of funds.

Some advantages of asset-based lending for banks are—

- a relatively high-yield loan is generated commensurate with the perceived credit risk of the borrower;
- a depository relationship is formed that provides income and enhances the bank's ability to monitor changes in the borrower's cash flow and overall financial condition;
- banking relationships with longstanding customers whose financial conditions no longer warrant traditional commercial bank loans can continue;
- new business is generated by prudently lending to financially weaker customers who could not qualify for normal commercial loans; and
- potential loss is minimized when the loan is collateralized by a percentage of the accounts receivable and inventory.

### CREDIT ANALYSIS

Although asset-based loans are collateralized and closely monitored, it is important to analyze the borrower's financial statements. Even if the collateral is of good quality and supports the loan, the borrower should demonstrate financial progress. Full repayment through collateral liquidation is normally a solution of last resort. An examiner should analyze the borrower's financial statements with particular emphasis on trends in working capital, review trade reports, analyze accounts receivable and inventory turnover, and review the agings of receivables and payables. Furthermore, the prompt payment of taxes, especially payroll taxes, should be verified. One reason for a company to obtain asset-based financing is to maximize discounts offered by

suppliers; therefore, it should pay creditors promptly upon receiving the financing.

Bank management's ability to recognize a customer's financial problems as they develop, and to initiate orderly liquidation, if necessary, is important in the supervision of asset-based financing. Theoretically, a borrower's line could be fully liquidated by discontinuing further advances, collecting the assigned receivables, and liquidating pledged inventory. However, such drastic action would most likely cause the borrower's business to close, resulting in a probable deterioration of the receivables from new disputes and in returns and offsets. Consequently, the bank usually notifies its borrower of a contemplated liquidation, which gives the borrower time to seek other means of continuing business so that the bank's loan may be liquidated in an orderly manner without losses or other adverse effects. Unless the bank has initiated an orderly liquidation, examiners should specially mention or classify receivable and inventory lines in which the borrower's financial position has declined so that continued financing is not prudent. When a liquidation is occurring, classification of the credit may not be necessary if the borrower's business is continuing, the existing collateral is of good quality, liquidation value sufficiently covers outstanding debt, and no collateral deterioration is anticipated.

A related issue concerning asset-based loans is the amount of excess availability associated with the revolving line of credit. The quantity of a borrowing company's excess availability is an excellent indicator of whether it has the capacity to service its loan. If a status report shows little availability, the borrower has used all of the cash that the pledged receivables and inventory are capable of generating under the asset-based line of credit. Since these loans may not yet be on the bank's watch list or problem-loan report, it is important for the examiner to track, over a fiscal-year period, a borrower's changing levels of availability when performing an analysis of creditworthiness. This analysis is especially critical for borrowers whose business is seasonal. Initial credit analyses of potential asset-based loan customers should include detailed projections showing that availability under revolving lines of credit at anticipated advance rates would be sufficient to meet the borrower's working-capital needs. Occasionally, overadvance lines are part of the initial credit facility.

Bank management must continually evaluate the realizable value of receivables and inventory

pledged. To do so, management should review the quality of the receivables and inventory pledged, including documentation; the safeguards imposed to ensure the authenticity and collectibility of the assigned receivables; and the loan agreement and compliance therewith. The information obtained is sometimes difficult to interpret unless it is related to other periods, comparable businesses, or industry statistics. Comparative analysis helps indicate the continuing value of the collateral.

Lender-liability exposure is a risk in all types of commercial lending, but especially in asset-based lending. Borrowers using asset-based financing are generally very dependent on its continuation, so an abrupt cessation of a line of credit would be more likely to result in legal action against a lender. To protect themselves as much as possible from lender-liability lawsuits, banks frequently use time notes (with renewal options). Time notes are supported by loan agreements that usually include more numerous and detailed loan covenants. Legal counsels for both the lender and borrower should approve the loan agreement and covenants. At times, the borrower may not comply with one or more covenants in a loan agreement. The lender may agree to waive specific covenant violations to give a borrower time to take corrective action. If a covenant such as a financial covenant requiring a minimum capital level is waived, the waiver should be formally communicated to the borrower in writing. The lender should avoid both not taking action for a period of time and not issuing a written waiver for a covenant violation. In either case, if a covenant violation is subsequently used as a reason to cancel an asset-based loan, the lender is more vulnerable to lender liability. The lender should be careful to be consistent in all actions regarding the borrower.

## ASSET-BASED LOAN AGREEMENTS

An asset-based loan agreement is a contract between a borrower and the bank that sets forth conditions governing the handling of the account and the remedies available in the event of default. The following areas should be addressed in the loan agreement:

- *Eligible accounts receivable.* This involves identifying classes of receivables that will not

be regarded as acceptable collateral. Certain types of receivables carry a higher degree of risk relative to the willingness and ability of account debtors to pay and, by their very nature, should be excluded from the lending formula. The following are typical classes of ineligible receivables:

—*Delinquent accounts.* Eligible receivables generally exclude accounts that are more than a given number of days delinquent, most often 60 days or more past due. Delinquency is frequently expressed in loan agreements as a given number of days from the invoice date, such as 90 days from the invoice date when payment is required in 30 days, which is the most common payment term. Expressing delinquency in days from the invoice date prevents a borrower from reducing the volume of ineligible delinquent accounts by giving dated terms (extending payment days). For example, accounts with 30-day trade terms that are becoming 60 days delinquent could otherwise be maintained in the eligible-receivable base by increasing payment terms to 90 days. Also, under what is commonly referred to as the “50 percent rule,” accounts with multiple invoices that have more than 50 percent of the total balance past due are excluded from the eligible-receivable base. For example, if a borrower’s customer owes payment for ten invoices, of which six are delinquent, all ten would be considered ineligible, not just the six that are delinquent. While 50 percent is standard industry practice, lenders may be more conservative and require ineligibility for an entire account if less than 50 percent of it is past due.

—*Contra accounts.* These usually arise when the borrower both sells to and purchases from the account debtor. The risk is the possibility of direct offset against these accounts.

—*Affiliate accounts.* These accounts, unlike contra-accounts, occur when a borrower sells to an account debtor, both of whom are associated through common ownership. Associated risks include forgiveness of debt on behalf of the affiliate and a temptation for the borrower to create fraudulent invoices.

—*Concentration accounts.* A lender may be vulnerable to loss if a large percentage of the dollar amount of receivables assigned is

concentrated in a few accounts. Too many sales, even to a good creditworthy customer, could ultimately cause problems should disputes arise over products or contracts. A common benchmark is that no more than 20 percent of the receivables assigned should be from one customer. Some lenders will use a percentage that is also subject to a dollar limit.

—*Bill-and-hold sales.* These occur when a product ordered by a buyer has actually been billed and is ready for shipment, but is held by the seller pending receipt of shipping instructions from the buyer. Bill-and-hold sales are not eligible as receivables to be loaned against because they are not fully executed transactions. A second party’s claim could be of little value when merchandise has not been shipped and there is no evidence of acceptance on behalf of the buyer.

—*Progress billings.* These are invoices issued on partial completion of contracts, usually on a percentage basis. This practice is standard in construction and other industries where long-term contracts are generally used. Failure to complete a contract could jeopardize the collectibility of progress receivables and, therefore, should generally not be considered eligible collateral. Moreover, failure to complete contracts can expose companies to lawsuits from their customers, who may be forced to pay higher prices to other parties to complete the contracts over much shorter time periods. The only exception for progress billings is when, on partial completion, there has been delivery of the product, and the contract clearly states that buyers have accepted the product and are responsible for payment of the product delivered.

—*Receivables subject to a purchase-money interest.* These include floor-plan arrangements, under which a manufacturer will frequently file financing statements when merchandise is delivered to the borrower. That filing usually gives the manufacturer a superior lien on the receivable. An alternative would be to enter into an agreement with the manufacturer, which specifies that rights to the receivables are subordinated to the bank.

• *Percentage advanced against eligible or acceptable accounts receivable.* The accounts-

receivable advance rate, typically in the range of 75 to 85 percent, must serve the two primary functions of providing adequate cash flow for the borrower and providing a margin that gives adequate protection for the lender. Protection for the lender requires a sufficient margin for the continual costs of collection and absorption of dilution in the receivables. Selecting the proper advance rate for a borrower involves understanding the amounts and causes of portfolio dilution. Causes of dilution that are positive include the offering of discounts and various allowances. Causes that are negative include merchandise returns, bad debts, product liability, or warranty claims. An abundance of negative causes, such as bad debts, might indicate poor receivable-management practices. A lender must know how dilution is occurring in each receivable portfolio to measure it continually. This knowledge should lead to proper advance-rate selection, resulting in a loan balance protected by a receivables base with sufficient liquidation value to repay the loan.

- *Percentage advanced against eligible inventory.* The inventory advance rate typically ranges from 35 to 65 percent for finished products. Marketability and accessibility of the inventory are key factors in determining the advance rate. Proper evaluation of the liquidation value of inventory requires a firm understanding of marketability in all the various inventory stages (raw materials, works-in-process, finished merchandise). Works-in-process often have very low marketability because of their unfinished nature, and they will typically carry a very low advance rate—if they are even allowed as eligible inventory. Conversely, the raw materials or commodities (such as aluminum ingots, bars, and rolls) have a broader marketability as separately financed collateral components. When setting advance rates, it is also important to consider whether inventory is valued at LIFO (last in, first out) or FIFO (first in, first out). In an inflationary environment, FIFO reporting will result in higher overall inventory values on the customer's books.

The above factors are considerations in the conduct of inventory audits performed in connection with the granting and monitoring of asset-based loans. These audits will generally discuss the inventory from a liquidation basis.

This information is critical in determining appropriate advance rates.

## Pledged Receivables

The following factors should be considered in evaluating the quality of receivables pledged:

- Standard procedures require that the bank obtain a monthly aging report of the accounts receivable pledged. The eligible receivables base is then calculated by deducting the various classes of ineligible receivables. Usually the eligible receivables base will be adjusted daily during the month following receipt of the aging report. If accounts are ledgered, the base will be increased by additional sales, as represented by duplicate copies of invoices together with shipping documents and/or delivery receipts received by the bank. The receivables base will be decreased daily by accounts-receivable payments received by the borrower, who then remits the payments to the bank. Another method of payment in which the bank has tighter control is a lockbox arrangement. Under this arrangement, receivables are pledged on a notification basis and the borrower's customers remit their payments on accounts receivable directly to the bank through deposit in a specially designated account. If accounts are not ledgered but a blanket assignment procedure is used, the borrower periodically informs the bank of the amount of receivables outstanding on its books. Based on this information, the bank advances the agreed percentage of the outstanding receivables. Receivables are also pledged on a non-notification basis, with payments on the receivables made directly to the borrower who then remits them to the bank. Proper management of any asset-based credit line requires that all payments on accounts receivable be remitted to the bank, with the accounts-receivable borrowing base reduced by a like amount. The borrower's working-capital needs should then be met by drawing against the asset-based credit line.
- Slower turnover of the pledged receivables can be a strong indication of deterioration in credit quality of accounts receivable.
- Debtor accounts that are significant to the bank borrower's business should be well rated and financially strong. Borrowers should also

obtain financial statements on their major customers to make credit decisions. These financial statements should be reviewed when the bank performs its periodic audits. In addition, the borrower should maintain an appropriate level of reserves for doubtful accounts. Credit insurance is often used, which indemnifies a company against noncollection of accounts receivable for credit reasons. When credit insurance is used, the asset-based lender should be named as beneficiary.

- Dilution or shrinking of the accounts-receivable borrowing base can result from disputes, returns, and offsets. A large or increasing volume of these transactions could adversely affect the bank's collateral position.

The following safeguards, which bank management should consider and the examiner should evaluate, ensure the authenticity and collectibility of the pledged accounts receivable:

- *Audits.* To verify the information supplied by the borrower to the bank, the bank should audit the borrower's books. Audits should occur several times a year at the borrower's place of business. For satisfactory borrowers, the audit is usually performed quarterly. However, audits can occur more frequently if deemed necessary. Individuals who perform bank audits should be independent of the credit function. The scope of an audit should include—
  - verification that the information on the borrowing-base certificate reconciles to the borrower's books;
  - review of concentrations of accounts;
  - review of trends in accounts receivable, accounts payable, inventory, sales, and costs of goods sold;
  - review of the control of cash proceeds;
  - determination that the general ledger is regularly posted;
  - verification of submitted aging reports;
  - review of bank reconciliations and canceled checks;
  - determination if any accounts receivable are being settled with notes receivable;
  - verification that the accounts-receivable ledger is noted to show that an assignment has been made to the bank;
  - determination on non-notification accounts that all payments are remitted to the bank and that positive written confirmations are issued timely (for example, semiannually);

- verification that all taxes, especially sales and payroll, are paid timely; and
- review of compliance with the loan agreement.

- *Confirmation.* To verify the authenticity of the pledged collateral, the bank should institute a program of direct confirmation. This procedure is particularly important if the accounts receivable are pledged on a non-notification basis, since the bank does not have the same control over debtor accounts as it does when the receivables are pledged on a notification basis. Direct confirmation should be made before the initial lending arrangement and periodically thereafter. Confirmation should be on a positive basis. The bank should obtain written approval from the borrower before confirming accounts receivable on a non-notification basis.

## Pledged Inventory

The following factors should be considered in evaluating the inventory pledged:

- A borrowing-base certificate, obtained from the borrower at least monthly, is normally used to calculate the dollar amount of inventory eligible for collateral. The borrowing-base certificate will show the different classes of inventory, such as raw materials, works-in-process, and finished goods. After this will be listed the different types of ineligible inventory, which will be subtracted to give the amount of eligible inventory. Finally, the advance rates are applied to the different classes of eligible inventory to determine the borrowing base.
- Factors affecting marketability, advance rates, and the decision whether to allow a class of inventory as eligible at even a low advance rate:
  - Obsolescence.* This could involve not only merchandise that is no longer in demand for various reasons, such as technological advances, but also style products, such as clothing, which obviously have a greater potential for obsolescence.
  - Seasonal goods.* It is necessary to know the seasonal highs and lows associated with a particular class of inventory, as well as the costs associated with these seasonal variations.

—*Oversupply*. If there is an oversupply in the general market of a particular class of inventory, then its value would be negatively affected.

—*Limited-use raw materials and finished goods*. These would be difficult to liquidate at a reasonable value.

Two other areas a lender must analyze in setting the inventory advance rate are the ease or difficulty, in terms of cost, of liquidating inventory in multiple locations, and the cost of maintaining certain inventory, such as food products that require refrigeration, in a salable state.

In addition to marketability, accessibility of the collateral is extremely important, as liquidation plans become meaningless if a lender cannot gain access to collateral. Constant vigilance is necessary to guard against actions that would preempt a lender's security interest in inventory. Following are some common actions that impede a lender's access to collateral:

- *Possessory liens*. A landlord lien is a common example. To protect their interest, lenders need to obtain landlord waivers to the lien.
- *Nonpossessory liens*. A purchase-money security interest is a common example. These are usually filed by trade suppliers against their customers.
- *Secret lien*. A tax lien is the most common example. To ensure that a loss of collateral does not occur, it is necessary to conduct

periodic lien searches if a borrower develops financial problems.

Commercial lenders often use outside appraisal firms to help them determine prudent inventory-advance rates. Also, normal industry practice for advance rates on different classes of inventory is available through the Commercial Finance Association Information Exchange.

Turnover rates should be analyzed to identify potential slow-moving or obsolete inventory, which should be subject to a lower or no advance rate. The borrower should establish inventory reserves if the volume of slow-moving or obsolete inventory is significant, and charge-off procedures should be in effect. Inventory should be adequately insured in relation to its location and amount. Furthermore, bill-and-hold merchandise and goods held on consignment should be physically segregated from other warehoused inventory and should not be included as inventory on the borrower's books or on the borrowing-base certificate submitted to the bank.

## UCC Requirements for Secured Transactions

Article 9 of the UCC applies to any transaction that is intended to create a security interest in personal property. For a detailed discussion of the UCC requirements regarding secured transactions, refer to section 2080.1, "Commercial and Industrial Loans."



# Asset-Based Lending

## Examination Objectives

Effective date May 1996

## Section 2160.2

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1. To determine if the policies, practices, procedures, and internal controls for accounts receivable and inventory financing are adequate.
2. To determine if bank officers are conforming to established guidelines.
3. To evaluate the portfolio for collateral sufficiency, credit quality, and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

# Asset-Based Lending

## Examination Procedures

Effective date November 2003

## Section 2160.3

1. If selected for implementation, complete or update the asset-based lending section of the internal control questionnaire.
  2. On the basis of the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
  3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal or external auditors, and determine if corrections have been accomplished.
  4. Obtain a trial balance of the customer liability records.
    - a. Agree or reconcile balances to department controls and the general ledger.
    - b. Review reconciling items for reasonableness.
  5. Using an appropriate technique, select borrowers for examination. Prepare credit line cards.
  6. Obtain the following information from the bank or other examination areas, if applicable:
    - a. past-due loans
    - b. loans in a nonaccrual status
    - c. loans on which interest is not being collected in accordance with the terms of the loan (Particular attention should be paid to loans that have been renewed without payment of interest.)
    - d. loans whose terms have been modified by a reduction of interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms
    - e. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
    - f. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
    - g. loan commitments and other contingent liabilities
    - h. Extensions of credit to employees, officers, directors, and principal shareholders and their interests, specifying which officers are considered executive officers
  7. Review the information received and perform the following procedures.
    - i. extensions of credit to executive officers, directors, and principal shareholders and their interests of correspondent banks
    - j. a list of correspondent banks
    - k. miscellaneous loan-debit and credit-suspense accounts
    - l. loans considered "problem loans" by management
    - m. Shared National Credits
    - n. specific guidelines in the lending policy
    - o. each officer's current lending authority
    - p. current interest-rate structure
    - q. any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee
    - r. reports furnished to the loan and discount committee or any similar committee
    - s. reports furnished to the board of directors
    - t. loans classified during the preceding examination
- a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.*
    - Participations only:
      - Test participation certificates and records, and determine that the parties share in the risks and contractual payments on a pro rata basis.
      - Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
      - Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
    - Procedures pertaining to *all* transfers:
      - Investigate any situations in which loans were transferred immediately before the date of examination to determine if any were transferred

to avoid possible criticism during the examination.

- Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
- Determine that the consideration received for low-quality loans transferred from the bank to an affiliate is properly reflected on the bank's books and is equal to the fair market value of the transferred loans. (While fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on these loans as well as an appropriate risk premium.) Section 23A of the Federal Reserve Act prohibits a state member bank from purchasing a low-quality asset.
- Determine that low-quality loans transferred to an affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.
- If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
  - (1) name of originating institution
  - (2) name of receiving institution
  - (3) type of transfer (i.e., participation, purchase or sale, swap)
  - (4) date of transfer
  - (5) total number of loans transferred
  - (6) total dollar amount of loans transferred
  - (7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
  - (8) any other information that would be helpful to the other regulator

b. *Miscellaneous loan-debit and credit-*

*suspense accounts.*

- Discuss with management any large or old items.
  - Perform additional procedures as deemed appropriate.
- c. *Loan commitments and other contingent liabilities.* Analyze the commitment or contingent liability if the borrower has been advised of the commitment, and analyze the combined amounts of the current loan balance (if any) and the commitment or other contingent liability exceeding the cutoff.
  - d. *Loans classified during the previous examination.*
    - Determine the disposition of loans so classified by transcribing—
      - current balance and payment status, or
      - date loan was repaid and source of payment.
    - Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank, or as a result of a participation, sale, or swap with another lending institution. If repayment was a result of a participation, sale, or swap, refer to step 7a of this section for the appropriate examination procedures.
  - e. *Uniform review of Shared National Credits.*
    - Compare the schedule of credits included in the uniform review of Shared National Credits Program with line cards to ascertain which loans in the sample are portions of Shared National Credits.
    - For each loan so identified, transcribe appropriate information from schedule to line cards. (No further examination procedures are necessary in this area.)
8. Consult with the examiner responsible for the asset/liability management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources. See "Instructions for the Report of Examination," section 6000.1, for the considerations to be taken into account when compiling maturity information for the gap analysis.
  9. Prepare line cards for any loan not in the sample that, on the basis of the information

- derived from the above schedules, requires in-depth review.
10. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, lease financing, and other loan areas, and together decide who will review the borrowing relationship.
  11. Obtain credit files for each loan for which line cards have been prepared. In analyzing the loans, perform the following procedures:
    - a. Analyze balance-sheet and profit-and-loss items as reflected in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
    - b. Review components of the balance sheet as reflected in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
    - c. Review supporting information and consolidation techniques for major balance-sheet items.
    - d. Ascertain compliance with provisions of loan agreements.
    - e. Review digests of officers' memoranda, mercantile reports, credit checks, and correspondence.
    - f. Review the following:
      - relationship between amount collected in a month on the receivables pledged as collateral and the borrower's credit limit
      - aging of accounts receivable
      - ineligible receivables
      - concentration of debtor accounts
      - financial strength of debtor accounts
      - disputes, returns, and offsets
      - management's safeguards to ensure the authenticity and collectibility of the assigned receivables
    - g. Analyze secondary support offered by guarantors and endorsers.
    - h. Ascertain compliance with established bank policy.
  12. Transcribe significant liability and other information on officers, principals, and affiliations of appropriate borrowers contained in the sample. Cross-reference line cards to borrowers, where appropriate.
  13. Determine compliance with laws and regulations pertaining to accounts receivable lending by performing the following steps.
    - a. *Lending limits.*
      - Determine the bank's lending limit as prescribed by state law.
      - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    - b. *Section 23A, Relations with Affiliates (12 USC 371c), and section 23B, Restrictions on Transactions with Affiliates (12 USC 371c-1), of the Federal Reserve Act, and Regulation W.*
      - Obtain a listing of loans to affiliates.
      - Compare the listing with the bank's customer liability records to determine its accuracy and completeness.
      - Obtain a listing of other covered transactions with affiliates (i.e., acceptance of affiliate's securities as collateral for a loan to any person).
      - Ensure that covered transactions with affiliates do not exceed the limits of section 23A and Regulation W.
      - Ensure that covered transactions with affiliates meet the collateral requirements of section 23A and Regulation W.
      - Determine that low-quality loans have not been purchased from an affiliate.
      - Determine that all covered transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
      - Determine that all transactions with affiliates comply with the market-terms requirement of section 23B and Regulation W.
    - c. *18 USC 215, Receipt of Commission or Gift for Procuring Loans.*
      - While examining the accounts receivable loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
      - Investigate any such suspected situation.
    - d. *Federal Election Campaign Act (2 USC 441b), Political Contributions and Loans.*
      - While examining the accounts receivable loan area, determine the existence of any loans in connection with any political campaign.
      - Review each such credit to determine

- whether it is made in accordance with applicable banking laws and regulations and in the ordinary course of business.
- e. *12 USC 1972, Tie-In Provisions.* While examining the accounts receivable loan area, determine whether any extension of credit is conditioned upon—
- obtaining or providing an additional credit, property, or service to or from the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service, or
  - the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit.
- f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows. (The examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment.)
- *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests.* While reviewing information relating to insiders that is received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps)—
    - test the accuracy and completeness of information about accounts receivable loans by comparing it with the trial balance or loans sampled;
    - review credit files on insider loans to determine that required information is available;
    - determine that loans to insiders do not contain terms more favorable than those afforded other borrowers;
    - determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features;
    - determine that loans to insiders do not exceed the lending limits imposed by Regulation O;
    - if prior approval by the bank's board was required for a loan to an insider, determine that this approval was obtained;
    - determine compliance with the various reporting requirements for insider loans;
    - determine that the bank has made provisions to comply with the disclosure requirements for insider loans; and
    - determine that the bank maintains records of public disclosure requests and the disposition of the requests for a period of two years after the dates of the requests.
  - *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
    - Obtain from or request that the examiners reviewing due from banks and deposit accounts verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
    - Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.
- g. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103.33), Retention of Credit Files.* Review the operating procedures and credit file documentation and determine if the bank retains records of each extension of credit over \$10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date thereof. (Loans secured by an interest in real property are exempt.)
14. Determine whether the consumer compliance examination uncovered any violations of law or regulation in this department. If violations were noted, determine whether corrective action was taken. Extend testing to determine subsequent compliance with

- any noted law or regulation.
15. Perform the appropriate steps in “Concentrations of Credits,” section 2050.3.
  16. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
    - a. delinquent loans
    - b. loans not supported by current and complete financial information
    - c. loans on which documentation is deficient
    - d. inadequately collateralized loans
    - e. classified loans
    - f. Small Business Administration delinquent or criticized loans
    - g. transfers of low-quality loans to or from another lending institution
    - h. concentrations of credit
    - i. extensions of credit to major shareholders, employees, officers, directors, and/or their interests
    - j. violations of laws and regulations
  - k. other matters concerning the condition of the department
  17. Evaluate the function for—
    - a. the adequacy of written policies, relating to accounts receivable financing;
    - b. the manner in which bank officers are conforming with established policy;
    - c. adverse trends within the accounts receivable financing department;
    - d. the accuracy and completeness of the schedules obtained from the bank;
    - e. internal control deficiencies or exceptions;
    - f. recommended corrective action when policies, practices, or procedures are deficient;
    - g. the competency of departmental management; and
    - h. other matters of significance.
  18. Update the workpapers with any information that will facilitate future examinations.

# Asset-Based Lending Internal Control Questionnaire

Effective date March 1984

## Section 2160.4

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

### POLICIES

- \*1. Has the board of directors, consistent with its duties and responsibilities, adopted written accounts receivable financing policies that—
  - a. establish procedures for reviewing accounts receivable financing applications,
  - b. establish standards for determining credit lines,
  - c. establish standards for determining percentage advance to be made against acceptable receivables,
  - d. define acceptable receivables,
  - e. establish minimum requirements for verification of borrower's accounts receivable, and
  - f. establish minimum standards for documentation?
- 2. Are accounts receivable financing policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

- \*3. Is the preparation and posting of subsidiary accounts receivable financing records performed or reviewed by persons who do not also—
  - a. issue official checks and drafts or
  - b. handle cash?
- \*4. Are the subsidiary accounts receivable financing records reconciled, at least monthly, to the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?
- 5. Are loan statements, delinquent account

collection requests, and past-due notices checked to the trial balances that are used in reconciling subsidiary records of accounts receivable financing loans with general ledger accounts, and are they handled only by persons who do not also handle cash?

- 6. Are inquiries about accounts receivable financing loan balances received and investigated by persons who do not also handle cash or pass adjustments?
- \*7. Are documents supporting recorded credit adjustments to loan accounts or accrued interest receivable accounts checked or tested subsequently by persons who do not also handle cash or initiate transactions (if so, explain briefly)?
- 8. Are terms, dates, weights, descriptions of merchandise, etc., shown on invoices, shipping documents, delivery receipts, and bills of lading scrutinized for differences?
- 9. Are procedures in effect to determine if the signatures shown on the above documents are authentic?
- 10. Are payments from customers scrutinized for differences in invoice dates, numbers, terms, etc.?

### LOAN INTEREST

- \*11. Is the preparation and posting of loan interest records performed or reviewed by persons who do not also—
  - a. issue official checks and drafts or
  - b. handle cash?
- 12. Are independent interest computations made and compared or tested to initial loan interest records by persons who do not also—
  - a. issue official checks and drafts or
  - b. handle cash?

### COLLATERAL

- \*13. Does the bank record, on a timely basis, a first lien on the assigned receivables for each borrower?
- 14. Do all loans granted on the security of the receivables also have an assignment of the inventory?

15. Does the bank verify the borrower's accounts receivable or require independent verification periodically?
16. Does the bank require the borrower to provide aged accounts receivable schedules periodically?
17. If applicable, are cash receipts and invoices block proven in the mailroom and subsequently traced to posting on daily transaction records?
18. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
19. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

## CONCLUSION

18. Is the foregoing information an adequate



Some member banks provide lending services to stock brokerage firms using marketable securities as collateral. While various financial services are offered, typically most banks make loans to brokerage firms to provide them with the funding needed to carry their securities portfolio. The securities can either be held by the bank or a tri-party custodian or pledged to the bank at a depository. Collateral securities can be in physical form or can be held at a depository in book-entry form.

To promote efficiency, a brokerage firm may use a depository to hold the securities it has pledged as collateral for a bank loan. Brokerage firms deposit shares of eligible securities with the depository, and the stock certificates representing those shares are registered in the name of a common nominee. Beneficial ownership of the securities is transferred through computerized book entries, thus eliminating the physical movement of the securities. The depository has physical control of the securities while they are on deposit. Loan arrangements are made between the broker and the lending bank, with the broker providing electronic instructions to the depository to debit the firm's account and credit that of the lending bank. The depository acknowledges the transaction to the lending bank and will not reverse the entry or allow partial withdrawals without authorization from that institution. Par-

ticipating banks receive daily reports showing their position in the program by broker name and type of security.

The New York Stock Exchange formed a subsidiary, the National Securities Clearing Corporation (NSCC), to provide equity clearance and continuous net settlement for the brokerage community. The Depository Trust Company in New York, under contract with the NSCC, handles the technical aspects of that operation, including final settlement. Collateral-pledging services may be offered by other depositories as well.

Book-entry transfer of ownership is limited to only those securities that are eligible for deposit in a depository. However, even if a security was depository-eligible, it would not be eligible for book-entry movement unless the lending bank was a direct or indirect participant in the depository. If the lending institution does not have a relationship, either directly or indirectly, with a depository, the securities would have to be delivered physically to the ultimate custodian (presumably the lending bank).

Securities lending is not always constrained by eligibility. Depending on the bank's underwriting standards, some banks may be willing to lend on the basis of securities that are not depository-eligible. This would preclude book-entry movement and require physical delivery.

# Securities Broker and Dealer Loans

## Examination Objectives

Effective date May 1996

## Section 2170.2

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1. To determine if policies, practices, procedures, objectives, and internal controls for securities broker and dealer loans are adequate.
2. To determine the types of loans (underwriting loan, day loan, inventory loan, margin loan, or guidance line) made, loan pricing and fees, loan-to-value ratios, and margin calls.
3. To evaluate credit quality, credit analysis, collateral and custody requirements, and procedures for lost and stolen securities.
4. To determine if bank officers are operating in conformance with the established guidelines.
5. To determine compliance with applicable laws and regulations, including Regulations T and U, the Securities Act of 1933, and the Securities Exchange Act of 1934.
6. To evaluate management information systems, particularly the lender's ability to ensure adequate collateral coverage by being able to automatically price collateral daily.
7. To determine the scope and adequacy of the audit function.
8. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

# Securities Broker and Dealer Loans

## Examination Procedures

Effective date March 1984

## Section 2170.3

1. If selected for implementation, complete or update the Securities Broker and Dealer Loans section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and of the work performed by internal/external auditors ascertain the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors, and determine if corrections have been accomplished.
4. Request the bank to supply:
  - a. Schedule of approved lines for each dealer including outstanding balances.
  - b. Delinquent interest billings, date billed amount of past-due interest.
5. Obtain a trial balance of all dealer accounts and:
  - a. Agree balances to department controls and general ledger.
  - b. Review reconciling items for reasonableness.
6. Using an appropriate technique, select borrowers to be reviewed.
7. Using the trial balance, transcribe the following information for each borrower selected onto the credit line cards.
  - a. Total outstanding liability.
  - b. Amount of approved line.
8. Obtain from the appropriate examiner the following schedules, if applicable to this area:
  - a. Past-due loans.
  - b. Loan commitments and other contingent liabilities.
  - c. Miscellaneous loan debit and credit suspense accounts.
  - d. Loans considered "problem loans" by management.
  - e. Each officer's current lending authority.
  - f. Current interest rate structure.
  - g. Any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee.
  - h. Reports furnished to the loan and discount committee or any similar committee.
  - i. Reports furnished to the board of directors.
  - j. Loans classified during the preceding examination.
  - k. A listing of loans charged-off since the preceding examination.
9. Review the information received and perform the following:
  - a. For miscellaneous loan debit and credit suspense accounts:
    - Discuss with management any large or old items.
    - Perform additional procedures as deemed appropriate.
  - b. For loans classified during the previous examination, determine disposition of loans so classified by transcribing:
    - Current balances and payment status, *or*
    - Date loan was repaid and sources of payment.
  - c. For loan commitments and other contingent liabilities, analyze if:
    - The borrower has been advised of the contingent liability.
    - The combined amounts of the current loan balance and the commitment or contingent liability exceed the cutoff.
  - d. Select loans which require in-depth review based on information derived when performing the above steps.
10. For those loans selected in step 6 above and for any other loans selected while performing the above steps, transcribe the following information from the bank's collateral record onto the credit-line cards:
  - a. A list of collateral held, including date of entry, and amount advanced.
  - b. A brief of the agreement between the bank and the dealer.
  - c. Evidence that the proper documentation is in place.
  - d. Details of any other collateral held.
11. The examiner should be aware that certain stock-secured purpose transactions with and for brokers and dealers are exempt from the

- margin restrictions of Regulation U. Refer to the regulation for a complete description of such transactions, which include the following:
- a. Temporary advances to finance cash transactions.
  - b. Securities in transit or transfer.
  - c. Day loans.
  - d. Temporary financing of distributions.
  - e. Arbitrage transactions.
  - f. Credit extended pursuant to hypothecation.
  - g. Emergency credit.
  - h. Loans to specialists.
  - i. Loans to odd-lot dealers.
  - j. Loans to OTC market makers.
  - k. Loans to third-market makers.
  - l. Loans to block positioners.
  - m. Loans for capital contributions.
12. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    - a. Delinquent loans, including a breakout of "A" paper.
    - b. Loans on which collateral documentation is deficient.
    - c. Recommended corrective action when policies, practices or procedures are deficient.
    - d. Other matters regarding the condition of the department.
  13. Prepare appropriate comments for examination report stating your findings with regard to:
    - a. The adequacy of written policies relating to dealer loans.
    - b. The manner in which bank officers are conforming with established policy.
    - c. Schedules applicable to the department that were discovered to be incorrect or incomplete.
    - d. The competence of departmental management.
    - e. Internal control deficiencies or exceptions.
    - f. Other matters of significance.
  14. Update the workpapers with any information that will facilitate future examinations.

# Securities Broker and Dealer Loans

## Internal Control Questionnaire

Effective date March 1984

## Section 2170.4

Review the bank's internal control, policies, practices and procedures for making and servicing loans. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written loan policies that:
  - a. Establish standards for determining broker and dealer credit lines?
  - b. Establish minimum standards for documentation?
2. Are such loan policies reviewed at least annually to determine if they are compatible with changing market conditions?
3. Is a daily record maintained summarizing loan transaction details, i.e., loans made, payments received and interest collected to support applicable general ledger account entries?
4. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?
5. Is an exception report produced and reviewed by operating management that encompasses extensions, renewals or any factors that would result in a change in customer account status?
6. Do customer account records clearly indicate accounts which have been renewed or extended?

### LOAN INTEREST

7. Is the preparation and posting of interest

records performed and reviewed by appropriate personnel?

8. Are any independent interest computations made and compared or adequately tested to initial interest records by appropriate personnel?
9. Are multicopy, prenumbered records maintained that:
  - a. Detail the complete description of collateral pledged?
  - b. Are typed or completed in ink?
10. Are receipts issued to customers covering each item of negotiable collateral deposited?
11. If applicable, are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?
12. Are appropriate steps with regard to Regulation U being considered in granting dealer and broker loans?

### CONCLUSION

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

### INTRODUCTION

Factoring is the purchase, essentially without recourse, of the accounts receivable of a client by a bank (the factor). Generally, factor clients are small, undercapitalized companies or start-up firms with limited liquidity that generally do not qualify for more traditional bank financing. In contrast to accounts receivable financing, where the client retains the credit and collection risk associated with the receivables, factoring transfers these risks to the factor. For the client, the principal advantage of factoring is the assurance that it will receive the proceeds of its sales, regardless of whether the factor is paid. Furthermore, the client does not have to maintain a credit department to evaluate the creditworthiness of customers, collect past-due accounts, or maintain accounting records on the status of receivables. The factor assumes these responsibilities. An additional advantage for the client is that under the terms of an "advance factoring" arrangement, the client receives payment for its receivables before the time stated on the invoice.

Two basic types of factoring service offered by the industry are (1) maturity factoring and (2) advance factoring. In maturity factoring, an average maturity due date is computed for the receivables purchased within a given time period, and the client receives payment on that date. Advance factoring is computed in the same way; however, the client has the option of taking a percentage of the balance due on a receivable in advance of the computed average maturity due date. The remainder of the receivable, sometimes called the "client's equity," is payable on demand at the due date.

### ACCOUNTING FOR FACTORING

The factor's balance sheet reflects the purchased accounts receivable as an asset account, "factored receivables," with "due to clients" as the corresponding liability. Usually, the balance of due-to-clients will be less than the factored receivables because of payments and advances to the clients. If, however, the factor makes advances to the client in amounts that exceed amounts due to the client, the advances will be shown as "overadvances." Overadvances are common and usually secured by other collateral.

The factoring agreement should set limits on the amount of overadvances available at any one time, generally based on specified collateral, such as the client's inventory. The relationship to inventory is based on the premise that the inventory will be sold, thus generating receivables that the factor has contracted to purchase. Proceeds from the factored receivables resulting from the sale of inventory are then used to repay the overadvance. If the overadvance is unsecured, it should be offset by a corresponding reduction in the "client's equity." The factor's income statement will show factoring commissions, which represent the discount on the receivables purchased, as income. Interest income for advances on the due-to-client balances may or may not be a separate line item.

Since factoring is a highly competitive industry, price cutting has reduced factoring commissions to the point that they provide minimal support to a factor's earnings. As a result, interest margins on factoring advances represent an increasingly important part of a factor's net income. An analysis of proportional changes in the due-to-clients account should provide valuable insight into the analysis of the earnings of a bank's factoring activities. As more clients take advances (reducing due-to-clients), profit margins should widen. Conversely, as the due-to-clients proportion of total liabilities rises, profit margins may be expected to narrow.

### FACTORING AGREEMENT, APPROVAL PROCEDURES, AND EXAMINER'S EVALUATION

The typical factoring agreement stipulates that all of a client's accounts receivable are assigned to the factor. However, the agreement between the factor and the client will usually state that receivables subject to shipping disputes and errors, returns, and adjustments are chargeable back to the client because they do not represent bona fide sales. The agreement will, in most instances, require that a reserve be established against the purchased receivables to ensure the factor's access to funds for any future charge-back adjustments.

The usual approval process requires the client to contact the factor's credit department before filling a sales order on credit terms. The credit

department conducts a credit review, determines the creditworthiness of the customer, and approves or rejects the sale. If the credit department rejects the sale, the client may complete the sale, but at its own risk. The most commonly rejected sales are those to affiliates, known bad risks, customers whose credit cannot be verified, and customers whose outstanding payables exceed the factor's credit line to that customer. Sales made by the client without the factor's approval are considered client-risk receivables, and the factor has full recourse to the client.

Once a sale has been made and the receivable assigned to the factor, whether or not the factor has approved it, the client's account will be credited for the net invoice amount of the sale. Trade or volume discounts, early payment terms, and other adjustments are deducted from the invoice amount. The receivable then becomes part of the client's "availability" to be paid immediately or at the computed date, depending on the basis of the factoring arrangement.

Each month the client receives an "accounts-current" statement from the factor, which details daily transactions. This statement reflects the daily assignments of receivables, remittances made (including overadvances and amounts advanced at the client's risk), deductions for term loans, interest charges, and factoring commissions. Credit memos, client-risk charge-backs, and other adjustments will also be shown. Client-risk charge-backs are the amounts deducted from the remittances to the client resulting from the failure of the client's customers to pay receivables that were advanced at the client's risk.

The accounts-current statement and the availability sheets are necessary for analyzing asset quality. The factor's ability to generate these reports daily is a basic control feature. Accounting systems for a high-volume operation probably will be automated, providing the factor with the data necessary to properly monitor the client. If a monitoring system is in place, the examiner should use the data provided in the asset analysis process.

The evaluation of a factoring operation includes a review of its systems and controls as well as an analysis of the quality of its assets. A major portion of a factor's assets will be factored receivables, for which the credit department has the responsibility for credit quality and collection. The other major portion of assets will consist of client loans and credit accommoda-

tions, such as overadvances and amounts advanced at the client's risk, for which the account officers are responsible.

## CREDIT DEPARTMENT EVALUATION

Because of its integral function in the credit and collection process, the credit department is the heart of a factoring operation. The department should maintain a credit file for each of its client's customers, and these files should be continually updated as purchases are made and paid for by the customers. These files should include financial statements, credit bureau reports, and details of purchasing volume and paying habits. Each customer should have an assigned credit line based on the credit department's review of the customer's credit capacity.

The objective of a credit department evaluation is to critique the credit and collection process and to assess departmental effectiveness. The examiner should have a copy of departmental policies and procedures as well as a verbal understanding of them before beginning the review. The factor's policies should include, at a minimum, well-defined field audit procedures, a fraud detection and monitoring plan, and a computer back-up plan. Customer files selected for review may be drawn from large and closely monitored customers, or they may be selected by a random sample.

## ASSET EVALUATION

The asset evaluation is a twofold process. The first part is to evaluate credit accommodations to each client. The second part is to evaluate customer receivables purchased by the factor at its own risk. For the first part of the process, the examiner should obtain a list that shows the aggregate of each client's credit exposure to the factor, both direct and indirect, including overadvances and receivables purchased at the client's risk. For the second part of the process, the examiner should obtain an aging schedule of factored receivables aggregated by customer but net of client-risk receivables. The selection of clients and customers for review should be based on the same selection methods as those used for the commercial loan review. Clients with a high "dilution" of receivables

(that is, customer nonpayment due to returns, shipping disputes, or errors) and those with client-risk receivables equal to 20 percent or more of factored volume might also be selected for review. Past-due factored volume is not a meaningful measure of client quality because a factor usually collects principal and interest payments directly from the client's availability.

A maturity client's availability is the sum of all factored receivables less trade and other discounts, factoring commissions, client-risk charge-backs, and other miscellaneous charges to the client's account. There may also be deductions for letters of credit and other credit accommodations. An advance client's availability would be further reduced by advances on the factored receivables, interest charges, and the reciprocal of the contractually agreed-upon "advance" percentage. This reciprocal, 20 percent in the case of a client who receives an 80 percent advance, is sometimes referred to as the client's equity in the factored receivables. Availability may be increased by liens on additional collateral, such as inventory, machinery and equipment, real estate, and other marketable assets.

A client's balance sheet will show a "due-from-factor" account instead of accounts receivable. The account balance may be somewhat lower than a normal receivables balance, thus distorting turnover ratios and other short-term ratios. A client can convert sales to cash faster with a factor than if it collected the receivables. The statement analysis should consider the client's ability to repay any advances received from the factor in the form of overadvances, term loans, or other credit accommodations. The analysis should also assess the client's ability to absorb normal dilution and the potential losses associated with client-risk receivables, particularly when these elements are unusually high.

## CLASSIFICATION GUIDELINES

When classifying the credit exposure to a client, the client-risk receivables portion of factored volume is the only amount subject to classification. Because of the recourse aspect, the balance is considered an indirect obligation rather than a direct obligation. Any other credit accommodations to a client that are not included in factored receivables, such as overadvances or term loans, are also subject to classification. Customer receivables purchased by the factor at its own risk are subject to classification. Care should be taken not to classify any receivables that have already been classified under client-risk exposure. Seasonal aspects of clients' businesses should be carefully analyzed in assessing asset quality based on classification data.

## CONCLUSION

Due to the large volume of daily transactions that typically flows through a factor, any internal control procedure that can be easily circumvented is a potential problem. The review of the department's internal systems and controls should be continuous throughout the examination. This review should include credit controls for both clients and customers. Since credit problems can develop rapidly in factoring, credit controls and systems must be responsive to the identification of these problems. Earnings and capital adequacy are evaluated based on the department's own performance. The factoring department's earnings trends may be evaluated by comparing the yield on assets for various periods. Factors are subject to the same price competition in the commercial finance market as accounts receivable financiers. Declining portfolio yields may reflect competitive pressures and may portend declining future profitability.



# Factoring

## Examination Objectives

Effective date May 1996

## Section 2180.2

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1. To determine if policies, practices, procedures, and internal controls for factoring are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the portfolio for performance, credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

# Factoring

## Examination Procedures

Effective date March 1984

## Section 2180.3

1. If selected for implementation, complete or update the Factoring section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest reviews done by internal/external auditors, and determine if appropriate corrections have been made.
4. Obtain a trial balance(s) of applicable asset and liability accounts and:
  - a. Agree or reconcile balances to department controls and general ledger.
  - b. Review reconciling items for reasonableness.
5. Obtain the following information:
  - a. A list of all clients with their outstanding balances including total factored receivables with those purchased at the client's risk segregated, overadvances, term loans and other credit accommodations.
  - b. If not included in 5a above, a list of amounts due to each client by the factor (availability reports).
  - c. Aging schedules of factored receivables by client and by customer with client risk receivables segregated.
  - d. Past due status reports for 5c, above.
  - e. Listings of all clients and customers considered to be problems.
  - f. Credits classified at the previous examination.
  - g. Concentration reports by client and by customer.
  - h. Exception reports highlighting dilution of factored receivables because of shipping disputes and errors, returns, or any other adjustments.
  - i. Credit commitments/lines for each client including amounts for overadvances and receivables purchased at the client's risk.
  - j. Credit lines for each customer.
  - k. Specific lending policy guidelines including each officer's current lending authority.
6. Current fee schedule.
- m. Any useful information obtained from the review of the minutes of the loan and discount committee or any similar committees.
- n. Reports furnished to the board of directors.
- o. Any other management reports maintained by the factoring department.
6. After consulting with the examiner-in-charge, determine the appropriate cut-off lines for:
  - a. Client's aggregate direct liability (i.e., overadvances, term loans and other credit accommodations).
  - b. Client's indirect liability (i.e., client-risk exposure).
  - c. Customer's factored receivables not including those in 6b above.
7. Transcribe information to line cards for all client and customer credits over the cut-off limits, for all credits recognized as problems, and for credits classified at the previous examination.
8. Cross reference clients and customers with the examiners assigned to other loan areas for common borrowers, and together decide who will review the borrowing relationship.
9. Obtain credit files for all clients and customers for whom line cards were prepared and analyze the accounts by performing the following procedures:
  - a. Analyze balance sheet and profit and loss items as reflected in current and preceding financial statements, determine the existence of any favorable or adverse trends.
  - b. Review components of the balance sheet as reflected in the current financial statements and determine the reasonableness of each item as it relates to the total financial structure.
  - c. Review supporting information for the major balance sheet items and the techniques used in consolidation, if applicable, and determine the primary sources of repayment and evaluate their adequacy.
  - d. Compare the amount of the credit line(s) with the lending officer's authority.
  - e. Determine compliance with the bank's established commercial loan policy.

In addition to the above procedures which are applicable to both client and customer accounts, the following additional procedures should be performed for client accounts only:

- f. Determine compliance with provisions of factoring agreements.
  - g. Review digest of officers' memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual program as set forth in the factoring agreement.
  - h. Relate collateral values to outstanding debt.
  - i. Compare fees charged to the fee schedule and determine that the terms are within established guidelines.
  - j. Analyze secondary support afforded by guarantors and endorsers.
10. Perform appropriate procedural steps in Concentration of Credits section, if applicable.
  11. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    - a. Delinquent amounts, segregating those considered "A" paper.
    - b. Violations of laws and regulations.
    - c. Accounts not supported by current and complete financial information or on which other documentation is deficient.
    - d. Concentrations of credit.
    - e. Criticized accounts.
    - f. Other matters regarding condition of asset quality.
  12. Evaluate the factoring department with respect to:
    - a. The adequacy of written policies relating to factoring.
    - b. The manner in which bank officers are operating in conformance with established policy.
    - c. Adverse trends within the factoring department.
    - d. Internal control deficiencies or exceptions.
    - e. Recommended corrective action when policies, practices or procedures are deficient.
    - f. The competency of departmental management.
    - g. Other matters of significance.
  13. Update the workpapers with any information that will facilitate future examinations.

# Factoring

## Internal Control Questionnaire

Effective date March 1984

## Section 2180.4

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

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written factoring policies that:
    - a. Establish procedures for reviewing factoring agreements?
    - b. Establish standards for determining client credit lines for each of the various types of accommodations available (i.e., factored receivables, client-risk receivables, overadvances, term loans, etc.)?
    - c. Establish standards for determining individual customer limits?
    - d. Require a client to contact the factor for approval before filling a sales order on credit terms?
    - e. Establish standards for approving the sales orders referred to above.
    - f. Establish standards for determining the percentage of advance that will be made against acceptable receivables in advance factoring arrangements?
    - g. Establish standards for determining the discount on factored receivables and the interest rate or fee charged for other credit accommodations?
    - h. Establish minimum standards for documentation?
  2. Are factoring policies reviewed at least annually to determine if they are compatible with changing market conditions?
- b. Handle cash?
  - \*4. Are the subsidiary factoring records reconciled, at least monthly, to the appropriate general ledger accounts, and reconciling items investigated by persons who do not also handle cash?
  5. Are accounts current statements, delinquent account collection requests, and past-due notices checked to the trial balances that are used in reconciling subsidiary records of factoring accounts with general ledger accounts, *and* handled only by persons who do not also handle cash?
  6. Are inquiries about factored balances received and investigated by persons who do not also handle cash?
  - \*7. Are documents supporting recorded credit adjustments to factored receivable accounts and the due-to-clients accounts checked or tested subsequently by persons who do not also handle cash (if so, explain briefly)?
  8. Are proper records maintained for approval of:
    - a. Customer orders?
    - b. Client credit accommodations?
  9. Are items, dates, weights, description of merchandise, etc., shown on invoices, shipping documents, delivery receipts, and bills of lading scrutinized for differences?
  10. Are procedures in effect to determine if the signatures shown on the above documents are authentic?
  11. Are payments from customers scrutinized for differences in invoice dates, numbers, terms, etc.?

### INTEREST AND FEES

- \*12. Is the preparation and posting of discount, interest, and fee records performed or reviewed by persons who do not also:
  - a. Issue official checks and drafts singly?
  - b. Handle cash?
13. Are independent discount, interest and fee computations made and compared or tested to initial records by persons who do not also:
  - a. Issue official checks and drafts?
  - b. Handle cash?

### INTERNAL CONTROL

- \*3. Is the preparation and posting of subsidiary factoring records performed or reviewed by persons who do not also:
  - a. Issue official checks and drafts?

**COLLATERAL**

- \*14. Does the bank record, on a timely basis, a first lien on the assigned receivables for each borrower?
- 15. Does the bank verify the borrower's accounts receivable or require independent verification on a periodic basis?
- 16. Does the bank review aged accounts receivable schedules on a regular basis?
- 17. If applicable, are cash receipts and invoices block proved in the mailroom and subsequently traced to posting on daily transaction records?

**CONCLUSION**

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

Bank premises and equipment includes land, buildings, furniture, fixtures, and other equipment, either owned or acquired by means of a capitalized lease, and any leasehold improvements. This section covers the fair valuation, general propriety, and legality of the bank's investment in premises and equipment. Other real estate owned and insurance coverage on fixed assets are discussed in other sections of this manual. (See sections 2200.1 and 4040.1, respectively.)

### ACQUISITION AND VALUATION

Banks obtain premises and equipment in three primary ways:

- directly purchasing premises and equipment with cash outlays or by incurring debt, such as a mortgage
- indirectly investing in a corporation that holds title to bank premises (the corporation may or may not be affiliated with the bank)
- leasing bank premises and equipment from a third party

The bank's initial investment in premises and equipment should be booked at cost, which should be determined according to generally accepted accounting principles (GAAP). Non-depreciable assets such as land and art should remain on the books at cost, unless the asset incurs a material and permanent decline in value. Under such circumstances, the asset should be reduced to its fair value on the books, and a loss should be recorded.

The bank should depreciate assets that, over time, decline in economic value. These assets may be depreciated differently for book and tax purposes, which may give rise to deferred tax assets and deferred tax implications. GAAP allows depreciation using various methods. These include time-factor methods such as straight-line and accelerated methods. Accelerated methods include sum-of-the-years' digits depreciation, declining-balance depreciation, double-declining-balance depreciation, and other accelerated methods. The Internal Revenue Service allows accelerated depreciation methods for many assets to encourage businesses to make capital investments. While many banks follow

these accelerated schedules for tax purposes, they may not depreciate these same assets as rapidly for book purposes.

Examiners should closely review internal controls for the bank's premises and equipment to ensure that these assets are properly safeguarded and appropriately recorded on the bank's books. Controls should be in place to inventory these assets and periodically review their economic usefulness. Furniture, fixtures, and equipment whose economic usefulness has expired or that are otherwise damaged, impaired, or obsolete should be written down to value. Assets that cannot be located should be accounted for as a loss.

### LEASES

Banks frequently lease their premises and equipment rather than own them. Leases should be accounted for in accordance with Financial Accounting Standards Board Statement No. 13 (FAS 13), "Accounting for Leases."<sup>1</sup> FAS 13 requires, among other things, that the lessee or lessor capitalize certain leases based upon four general criteria. A lease is classified as a capital lease or an operating lease depending upon whether (1) there will be a transfer of title at the end of the lease term, (2) the lease contains a bargain purchase option that will be activated at some future date, (3) the lease term is equal to 75 percent or more of the estimated economic life of the leased property, and (4) the present value of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased asset. For the *lessee*, a lease is capitalized if any one of the four general criteria is met. For the *lessor*, a lease is capitalized if any one of the four general criteria is met, but two revenue recognition criteria must also be met. The following recognition criteria are applicable to the lessor: (1) the collectability of the minimum lease payments must be reasonably assured and (2) there are no important uncertainties surrounding the amount of unreimbursed cost yet to be incurred by the lessor. The instructions for the

1. Portions of Statement No. 13 have been amended by Statement Nos. 17, 22, 23, 26, 27, 28, 29, 34, 71, 77, 91, 96, 98, 109, 125, 135, 145, and 157. In addition the FASB released Interpretations 19, 21, 23, 24, 26, and 27. It has also issued several Technical Bulletins to clarify certain viewpoints or positions involving the standard for leases.

preparation of the FFIEC Consolidated Reports of Condition and Income (Call Report) further detail the capitalization of leases and specify treatment for leases. For the lessee, if a lease is required to be capitalized, the lease is recorded as a capitalized lease asset and as a corresponding liability. The amount capitalized would be the present value of the minimum required lease payments over the noncancelable term, as defined in the lease, plus the present value of the payment required under the bargain-purchase option, if any, less any portion of the payments representing executory expenses such as insurance, maintenance, and taxes to be paid by the lessor. The amortization period should be the life of the lease or a period established in a manner consistent with the lessee's normal schedule of depreciation for owned assets. The requirements of FAS 13 are somewhat complex, and examiners who have questions on the capitalization of leases should refer to that statement for necessary detail. Leases not required to be capitalized are called "Operating Leases," and lease payments associated with them are charged to expense over the term of the lease as they become payable.

Lease arrangements between a state member bank and its parent company or other affiliated entity should be reviewed in detail. Examiners should ensure that the lease arrangement is reasonable in relation to the cost of the asset, its current fair value, or similar lease arrangements in the current market. Transactions that appear to be self-serving or otherwise unreasonable to the bank should be criticized.

## PROCEDURES FOR INVESTING IN BANK PREMISES

Section 24A of the Federal Reserve Act (12 U.S.C. 371d) requires state member banks to obtain Federal Reserve System approval to make additional investments that would cause the bank's total bank premises investments to exceed certain percentage-of-capital thresholds. Section 208.21 of Regulation H implements this requirement. Note that for purposes of this requirement, "bank premises investments" include a bank's direct investment in premises; its investment in the stock (or other ownership interests), bonds, debentures, or other such obligations of any company holding the premises of the bank; and loans made to (or on security of) any company

holding the premises of the bank.

### 150 Percent Threshold for Well-Managed, Well-Capitalized Banks

A bank that is well-capitalized (as defined in Regulation H) and has a CAMELS composite rating of 1 or 2 (as of its most recent examination) must obtain prior Federal Reserve System approval for a bank premises investment only if the investment would cause the bank's total bank premises investments (plus any debt incurred by any bank premises company affiliated with the bank) to exceed 150 percent of the bank's perpetual preferred stock (and related surplus) plus its common stock (and related surplus).

### 100 Percent Threshold for Other Banks

A bank not eligible for the 150 percent threshold must obtain prior Federal Reserve System approval for a bank premises investment only if the investment would cause the bank's total bank premises investments (plus any debt incurred by any bank premises company affiliated with the bank) to exceed the bank's perpetual preferred stock (and related surplus) plus its common stock (and related surplus).

### *Bank Premises Investment that Exceeds the Applicable Threshold*

To make a bank premises investment that exceeds the applicable threshold, a bank must notify the appropriate Reserve Bank of the proposed investment at least 15 days before making it, and must not have been advised by the Reserve Bank prior to the end of the 15-day period that the investment is subject to further review.

When considering the approval of domestic-branch applications, the Board follows the guidelines detailed in section 208.6(b) of Regulation H. The Board will analyze whether the bank's investment in premises for the branch is consistent with section 208.21 of Regulation H. Reserve Banks, under their delegated authority, can also perform this analysis.

## FUTURE USE AND CLASSIFICATION AS OREO

Member banks are encouraged to plan for their future premises needs. However, examiners should not arbitrarily classify real estate acquired for future use. The examiner needs to review the circumstances surrounding each individual case and determine if the period of time which the property has been held is reasonable relative to the intended use. Real estate acquired for future expansion is considered “other real estate owned” from the date when its use for banking is no longer contemplated. In addition, former banking premises are considered other real estate owned from the date of relocation to new banking quarters.

## TRANSACTIONS WITH INSIDERS

If a member bank contracts for or purchases any securities or other property from any of its directors, any firm its directors are members of, or any of its affiliates, the transaction is subject to the requirements of sections 22(d) and 23B of the Federal Reserve Act and the Board’s Regu-

lation W. These sections require that transactions be made in the regular course of business on terms not less favorable to the bank than those offered to others. When the purchase is authorized by a majority of the board of directors who have no interest in the sale of such securities or property, the authority should be evidenced by affirmative vote or written assent. In addition, a member bank may sell securities or other property to any of its directors subject to the same stipulations.

## EXAMINATION CONSIDERATIONS

As indicated earlier, the examiner responsible for bank premises and equipment should assess the appropriateness of the bank’s investment in this area and the overall impact of occupancy expense on the bank. Even if a bank’s total investment in bank premises is within legal limits and all of its fixed assets are valued fairly, its total expenditures for or investment in premises and equipment may be inappropriate relative to earnings, capital, or the nature and volume of the bank’s operations.



# Bank Premises and Equipment Examination Objectives

Effective date May 1996

## Section 2190.2

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

# Bank Premises and Equipment Examination Procedures

Effective date October 2009

## Section 2190.3

1. If selected for implementation, complete or update the Bank Premises and Equipment section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors (see separate program) determine the scope of the examination.
3. Evaluate policies and procedures regarding premises and fixed assets. Determine that the guidelines discourage conflicts of interest or self dealing with vendors, servicers, and insurers. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Determine that audit procedures consider premises and equipment that are held by the bank, a subsidiary, or an affiliate realty corporation as part of sale and leaseback transactions or as lease-purchase contracts.
  - If significant, auditors should ensure capitalized lease designations are appropriate and in accordance with GAAP.
  - If part of sale-leaseback agreement, they should review for proper accounting treatment and in accordance with GAAP.

Also obtain a listing of any audit deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if appropriate corrections have been made.

4. Obtain a summary of changes in fixed asset and depreciation ledgers that have occurred since the previous examination. Also, balance each of the fixed asset subsidiary accounts to the appropriate general ledger control account.
5. Determine, by reference to excerpts of the minutes of meetings of the board of directors, that all major additions and disposals of fixed assets are properly documented.
6. Determine whether information and reporting regarding fixed assets to senior management and the board are adequate.
7. Determine by observation and inquiry of appropriate management personnel, that the bank's books have been properly adjusted to reflect significant assets that are idle, abandoned, or useless.
8. In instances where bank premises are sub-

ject to lease, perform the following for:

- a. Bank as lessee:
    - For each lease which has an initial lease period of more than one year, obtain from the bank:
      - Name of lessor.
      - Expiration date.
      - Required minimum annual payments.
      - Current status.
      - Renewable option provisions.
  - b. Bank as lessor:
    - Determine if the bank relies on rental income to contribute to payment of occupancy expenses and if that income is material. As a general guideline, rental income is considered material if it equals or exceeds 1 percent of total operating revenues.
    - If rental income is material, analyze the bank's potential exposure from:
      - Concentrations among lessees.
      - Impending expiration of major leases.
      - Lack of creditworthiness of lessee.
      - Non-compliance with lease terms.
9. Forward to the examiner assigned "Funds Management:"
    - a. The total minimum annual commitment under various lease agreements.
    - b. The dollar amount of any significant, future fixed asset expenditure(s).
  10. Determine, by reference to appropriate workpapers (see "Insurance Coverage"), that fire and hazard insurance, in sufficient amounts, is in force.
  11. Perform a limited test of the records to verify that depreciation methods are consistent with bank policy, prior years' calculations, GAAP, and applicable IRS laws.
  12. Analyze the bank's investment in fixed assets and the annual expenditures required to carry them and determine their reasonableness relative to:
    - a. Present total capital structure.
    - b. Present annual earnings.
    - c. Projected future earnings.
    - d. Nature and volume of operations.
  13. Test for compliance with the limitations set forth in section 24A of the Federal Reserve Act.

14. Determine that real estate held for future expansion still qualifies as bank premises.
15. Review the following with appropriate management personnel or prepare a memo to other examiners for their use in reviewing with management:
  - a. Any internal control deficiencies.
  - b. Any policy deficiencies.
  - c. Any violations of law.
16. Review your findings with respect to the propriety and adequacy of present and projected investment in bank premises. In formulating your conclusion, consider:
  - a. Size of bank.
  - b. Cash flow forecasts.
  - c. Existing fixed asset investments.
  - d. Anticipated growth potential.
  - e. Bank programs to maintain assets at their most optimal use.
  - f. The policy used to establish the useful life of each asset.
  - g. Control of inventory procedures.
  - h. Systems used to record all asset purchases, sales and retirements between physical inventories.
17. Prepare comments regarding deficiencies or violations of law for inclusion in the examination report.
18. Prepare the appropriate write-ups for the report of examination.
19. Update workpapers with any information that will facilitate future examinations.

# Bank Premises and Equipment Internal Control Questionnaire

Effective date March 1984

Section 2190.4

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

## CUSTODY OF PROPERTY

- \*1. Do the bank's procedures preclude persons who have access to property from having "sole custody of property," in that:
  - a. Its physical character or use would make any unauthorized disposal readily apparent?
  - b. Inventory control methods sufficiently limit accessibility?

## ADDITIONS, SALES, AND DISPOSALS

- 2. Is the addition, sale or disposal of property approved by the signature of an officer who does not also control the related disbursement or receipt of funds?
- 3. Is board of directors' approval required for all major additions, sales or disposals of property (if so, indicate the amount that constitutes a major addition, sale or disposal \$\_\_\_\_\_)?
- \*4. Is the preparation, addition and posting of property additions, sales and disposals records, if any, performed and/or adequately reviewed by persons who do not also have sole custody of property?
- \*5. Are any property additions, sales and disposals records, balanced, at least annually, to the appropriate general controls by persons who do not also have sole custody of property?
- 6. Are the bank's procedures such that all additions are reviewed to determine whether they represent replacements and that any replaced items are cleared from the accounts?

- 7. Do the bank's procedures provide for signed receipts for removal of equipment?
- \*8. Do the bank's policies cover procedures for selecting a seller, servicer, insurer, or purchaser of major assets (through competitive bidding, etc.), to prevent any possibility of conflict of interest or self-dealing?
- 9. Do the review procedures provide for appraisal of an asset to determine the propriety of the proposed purchase or sales price?

## DEPRECIATION

- \*10. Is the preparation, addition and posting of periodic depreciation records performed and adequately reviewed by persons who do not also have sole custody of property?
- 11. Do the bank's procedures require that regular charges be made for depreciation expense?
- \*12. Are the subsidiary depreciation records balanced, at least annually, to the appropriate general controls by persons who do not also have sole custody of property?

## PROPERTY RECORDS

- \*13. Are subsidiary property records posted by persons who do not also have sole custody of property?
- \*14. Are the subsidiary property records balanced, at least annually, to the appropriate general ledger accounts by persons who do not also have sole custody of property?

## BANK AS LESSOR (BANK PREMISES AND BANK-RELATED EQUIPMENT ONLY)

- \*15. Do policies provide for division of the duties involved in billing and collection of rental payments?
- 16. Are the lease agreements subject to the same direct verification program applied to other bank assets and liabilities?

17. Are credit checks performed on potential lessees?
18. Do policies provide for a periodic review of lessees for undue concentrations of affiliated or related concerns?

### BANK AS LESSEE (BANK PREMISES AND BANK-RELATED EQUIPMENT ONLY)

19. Does the bank have a clearly defined method of determining whether fixed assets should be owned or leased, and is supporting documentation maintained by the bank?
20. Are procedures in effect to determine whether a lease is a "capital" or an "operating" lease as defined by the generally accepted accounting principles?
21. Do the bank's operating procedures provide, on "capital" leases, that the amount capitalized is computed by more than one individual and/or reviewed by an independent party?

### OTHER PROCEDURES

- \*22. Is the physical existence of bank equipment periodically checked or tested, such as by a physical inventory, and are any

- differences from property records investigated by persons who do not also have sole custody of property?
23. Do the bank's procedures provide for serial numbering of equipment?
24. Are the bank's policies and procedures on property in written form?
25. Is the benefit of expert tax advice obtained prior to final decision-making on significant transactions involving fixed assets?
- \*26. Does the bank maintain separate property files which include invoices (including settlement sheets and bills of sale, as necessary), titles (on real estate, vehicles, etc.) and other pertinent ownership data as part of the required documentation?

### CONCLUSIONS

27. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant additional deficiencies that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
28. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

A state member bank's authority to hold real estate is governed by state law. A bank is permitted to include owned real estate in its premises account if the real estate serves as premises for operations or is intended to be used as premises. In addition, a bank may hold other real estate owned (OREO), which is defined below. State laws dictate the terms and conditions under which state-chartered banks may acquire and hold OREO.

### DEFINITION

Other real estate comprises all real estate, other than bank premises, owned or controlled by the bank or its consolidated subsidiaries, including real estate acquired through foreclosure, even if the bank has not received title to the property. Bank holdings of OREO may arise from the following events:

- the bank purchases real estate at a sale under judgment, decree, or mortgage when the property secured debts previously contracted;
- a borrower conveys real estate to the bank to fully or partially satisfy a debt previously contracted (acceptance of deed in lieu of foreclosure);
- real estate is obtained in exchange for future advances to an existing borrower to fully or partially satisfy debts previously contracted;
- a bank takes possession (although not necessarily title) of collateral in a collateral-dependent real estate loan (i.e., an in-substance foreclosure);
- a bank has relocated its premises and has not yet sold the old premises;
- a bank abandons plans to use real estate as premises for future expansion; and
- a bank has foreclosed real estate that is under contract for sale.

There are three major phases of the OREO life cycle: acquisition, holding period, and disposition.

### ACCOUNTING AND REPORTING STANDARDS

The accounting and reporting standards for the

acquisition phase are set forth in Accounting Standards Codification (ASC)<sup>1</sup> 310-40, Receivables-Troubled Debt Restructurings by Creditors (formerly known as FAS 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings"); ASC 360-10-30, Property, Plant and Equipment-Initial Measurement (formerly included in FAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets"); and ASC 360-10-35, Property, Plant and Equipment-Subsequent Measurement. The disposition of other real estate is addressed in ASC 360-20-40, Property, Plant and Equipment-Real Estate Sales-Derecognition (formerly within FAS 66, "Accounting for Sales of Real Estate"), which includes specific criteria for the recognition of profit. Reference should also be made to the instructions for the FFIEC Consolidated Report of Condition and Income for a Bank with Domestic and Foreign Offices (Call Report) as to the reporting of OREO transactions.

### TRANSFER OF ASSETS TO OREO

Real estate assets transferred to OREO should be accounted for individually (on an asset-by-asset basis) on the date of transfer. Each transferred real estate asset should be recorded at its "fair value" less estimated cost to sell the asset. This "fair value" becomes the cost of the asset. "Fair value" is the amount the creditor should reasonably expect to receive for the asset in a current sale between a willing buyer and a willing seller (that is, not a forced liquidation sale).

The recorded amount of a loan (or an investment in a loan) at the time of foreclosure involving real estate transferred to OREO is the unpaid balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest. Any excess of the recorded amount of the loan over the transferred property's fair value is a loss that must be charged against the allowance for loan and lease losses (ALLL) immediately upon the property's

1. This section uses the Financial Accounting Standards Board (FASB)'s *Accounting Standards Codification* (ASC) numbering system, references, and titles, which it approved in June 2009 for its authoritative pronouncements. Within this section, each first "ASC" reference is followed by its "pre-codification" FASB reference and title.

transfer to OREO. If the fair value (less costs to sell) of the property exceeds a recorded loan amount, the excess should be reported as a recovery of a previous charge-off or in current earnings, as appropriate. Legal fees and other direct costs incurred by the bank should generally be included in expenses.

The value of OREO properties must be reported at the fair value minus estimated selling expenses or the recorded loan amount. For example, if the recorded investment in the property is \$125, the fair value of the property is \$100, and the estimated selling expenses are \$6, the carrying value for this property would be \$94. The difference between the recorded loan amount of \$125 and the fair value of \$100 minus the \$6 estimated cost to sell the property, or \$31, would be charged to the ALLL at the time the property was transferred to OREO. Subsequent to the acquisition date, the OREO property should be reported at the lower of the cost of the property (\$94 in this case) or the fair value of \$100 less cost to sell of \$6, which is also \$94. Any subsequent declines in value should be recorded by creating a valuation allowance.

Alternatively, if the recorded loan amount is \$250, the property's fair value is \$275, and the estimated selling expenses are \$18, the property's carrying value would be \$257 (the property's fair value of \$275 less estimated cost to sell of \$18). The \$7 difference between the fair value (less costs to sell) and the recorded loan amount would be recorded as a recovery of a previous charge-off or in current earnings, as appropriate. Before recording the \$7 in earnings, significant scrutiny should be applied to understand why the borrower would risk losing the equity in the property. Additionally, in some states, lenders are required to return recovered amounts, in excess of the amount owed, to the borrower.

## EVALUATIONS OF REAL ESTATE TO DETERMINE THE CARRYING VALUE OF OREO

The transfer of real estate pledged as collateral for a loan to OREO is considered to be a "transaction involving an existing extension of credit" under 12 CFR 225.63(a)(7) and is exempt from Regulation Y's appraisal requirement. However, under 12 CFR 225.63(b), the bank

must obtain an "appropriate evaluation" of the real estate that is "consistent with safe and sound banking practices" to establish the carrying value of the OREO. A bank may elect, but is not required, to obtain an appraisal to serve as the "appropriate evaluation." Until the evaluation is available, a bank should rely on its best estimate of the property's value to establish the carrying value. The federal banking agencies have issued appraisal and evaluation guidelines to provide guidance to examining personnel and federally regulated institutions regarding prudent appraisal and evaluation policies, procedures, practices, and standards.

The appraisal or evaluation should provide an estimate of the parcel's market value. (Refer to section 4140.1, "Real Estate Appraisals and Evaluations.") The subsection titled, "Appraisal Content," includes a definition of *market value*. Generally, appraisals or evaluations contain an estimate of the property's fair value based on a forecast of expected cash flows, discounted at an interest rate that is commensurate with the risks involved. The cash flow estimate should include projected revenues and the costs of ownership, development, operation, marketing, and sale. In such situations, the appraiser or evaluator should fully describe the definition of value and the market conditions that have been considered in estimating the property's fair value.

## PROPERTY ACQUIRED THROUGH FORECLOSURE—JUNIOR LIENHOLDER

When a bank acquires a property through foreclosure as a junior lienholder, whether or not the first lien has been assumed, the property should be recorded as an asset at its fair value less its estimated cost to sell. Any senior debt (principal and accrued interest) should be recorded as a corresponding liability. Senior debt should not be netted against the assets. Any excess of the recorded loan amount over the property's fair value less estimated cost to sell should be charged off to the ALLL. The recorded investment may not exceed the sum of any senior and junior debt. Payments made on senior debt should be accounted for by reducing both the asset and the liability. Interest that accrues on the senior debt after foreclosure should be recognized as interest expense.

## COLLATERAL-DEPENDENT LOANS

Collateral-dependent loans are those for which repayment is expected to be provided solely from the underlying collateral when there are no other available and reliable sources of repayment. Guidance for the treatment of certain troubled debts and collateral dependent loans is found in ASC 310-40, Receivables-Troubled Debt Restructurings by Creditors (formerly within FAS 15, as amended by FAS 114 and Accounting Principles Board Opinion no. 21, "Interest on Receivables and Payables"). According to the instructions in the Call Report, collateral-dependent real estate loans should be transferred to OREO only when the lender has taken possession (title) of the collateral; otherwise they should remain categorized as loans. To facilitate administration and tracking, however, banks may choose to include a collateral-dependent real estate loan in the OREO portfolio as potential or probable OREO. Impairment of a collateral-dependent loan must be measured using the fair value of the collateral. In general, any portion of the recorded amount of a collateral-dependent loan in excess of the fair value of the collateral (less the estimated cost to sell) that can be identified as uncollectible should be promptly charged off against the ALLL. Examiners should review these loans using the same criteria applied to OREO.

## PROPERTY ACQUIRED FOR FUTURE USE

Property the bank originally acquired for future use as premises, but for which plans have been abandoned, and property that formerly served as bank premises, should be accounted for at the lower of (1) its fair value less cost to sell or (2) the cost of the asset on the date of transfer to OREO. Any excess of book value over fair value should be charged to other operating expense during the current period.

## CARRYING VALUE OF OREO

A bank should have a policy for periodically determining the fair value of its OREO property by obtaining an appraisal or an evaluation, as appropriate. While the Federal Reserve has no

prescribed time frame for when a bank should reappraise or reevaluate its OREO property, the bank's policy should conform to state law, if applicable, and take into account the volatility of the local real estate market. A bank should determine whether there have been material changes to the underlying assumptions in the appraisal or valuation that have affected the original estimate of value. If material changes have occurred, the bank should obtain a new appraisal or evaluation based on assumptions that reflect the changed conditions.

## ACCOUNTING FOR SUBSEQUENT CHANGES IN FAIR MARKET VALUE

Charges for subsequent declines in the fair value of OREO property should never be posted to the ALLL. If an appraisal or evaluation indicates a subsequent decline in the fair value of an OREO property, the loss in value should be recognized through the income statement by a charge to earnings. Banks should attempt to determine whether a property's decline in value is not recoverable, taking into consideration each property's characteristics and existing market dynamics. The preferred treatment for nonrecoverable losses in value is the direct write-down method, in which the charge to expenses is offset by a reduction in the OREO property's carrying value. If the reduction in value is deemed temporary, the charge to earnings may be offset by establishing a valuation allowance specifically for that property. In the event of subsequent appreciation in the value of an OREO property, the increase can only be reflected by reducing this valuation allowance or recognizing a gain upon disposition, but never by a direct write-up of the property's value. A change to the valuation allowance should be offset with a debit or credit to expense in the period in which it occurs.

In addition to the preceding treatment of the write-down in the OREO value, the previous subsection "Transfer of Assets to Other Real Estate Owned" discusses setting up a valuation allowance for estimated selling expenses associated with the sale of the other real estate. The balance of this valuation allowance can fluctuate based on changes in the fair value of the property held, but it can never be less than zero. The following examples are presented to illustrate the treatment that subsequent depreciation



and appreciation would have on OREO properties.

## Depreciation in OREO Property Value

Assume a bank has written down its initial recorded investment in an OREO property from \$125 to its fair value of \$100 minus costs to sell (assume costs to sell of \$6), or \$94. Assume that a new appraisal indicates a fair value of \$90, with reduced estimated selling expenses of \$5. If the bank determines this decline in value is nonrecoverable, the bank must expense the depreciation of \$9.

## Appreciation in OREO Property Value

Assume a bank has written down its recorded investment in an OREO property to its fair value of \$110 less costs to sell of \$10, or \$100, and it subsequently created a valuation allowance for the \$10 temporary decline in value. A new appraisal indicates an increase in the fair value of the property to \$112 less costs to sell of \$9, or \$103. Notwithstanding the property's increased fair value, the recorded investment value cannot be increased above \$100. The valuation allowance for selling expenses can never be less than zero, thus prohibiting an increase in the value of the property above the recorded investment. In this case, the bank would reduce the valuation allowance to zero, which would increase the recorded value to \$100.

## Accounting for Income and Expense

Gross revenue from OREO should be recognized in the period in which it is earned. Direct costs incurred in connection with holding an OREO property, including legal fees, real estate taxes, depreciation, and direct write-downs, should be charged to expense when incurred.

A bank can expend funds to develop and improve OREO when it appears reasonable to expect that any shortfall between the property's fair value and the bank's recorded book value will be reduced by an amount equal to or greater than the expenditure. Such expenditures should not be used for speculation in real estate. The economic assumptions relating to the bank's

decision to improve a particular OREO property should be well documented. Any payments for developing or improving OREO property are treated as capital expenditures and should be reflected by increasing the property's carrying value to the extent that those expenditures increase the value of the property.

## DISPOSITION OF OREO

OREO property must be disposed of within any holding period established by state law and, in any case, as soon as it is prudent and reasonable. Banks should maintain documentation reflecting their efforts to dispose of OREO property, which should include

- a record of inquiries and offers made by potential buyers,
- methods used in advertising the property for sale whether by the bank or its agent, and
- other information reflecting sales efforts.

The sale or disposition of OREO property is considered a real estate-related financial transaction under the Board's appraisal regulation. A sale or disposition of an OREO property that qualifies as a federally related transaction under the regulation requires an appraisal conforming to the regulation. A sale or disposition that does not qualify as a federally related transaction nonetheless must comply with the regulation by having an appropriate evaluation of the real estate, that is consistent with safe and sound banking practices.

The bank should promptly dispose of OREO if it can recover the amount of its original loan plus additional advances and other costs related to the loan or the OREO property before the end of the legal holding period. The holding period generally begins on the date that legal title to the property is transferred to the bank, except for real estate that has become OREO because the bank no longer contemplates using it as its premises. The holding period for this type of OREO property begins on the day that plans for future use are formally terminated. Some states require OREO property to be written off or depreciated on a scheduled basis, or to be written off at the end of a specified time period. The bank should determine whether such requirements exist and comply with them.

## Financing Sales of OREO

Gains and losses resulting from a sale of OREO properties for cash must be recognized immediately. A gain resulting from a sale in which the bank provides financing should be accounted for under the standards described in ASC 360-20-40, Property, Plant and Equipment-Real Estate Sales-Derecognition (formerly within Statement of Financial Accounting Standards 66 (FAS 66)). ASC 360-20-40 recognizes that differences in terms of the sale and in selling procedures lead to different profit recognition criteria and methods. The standards establish five different methods of accounting for dispositions of real estate. In practice, most banks have primarily used either the full accrual or the deposit method. The full accrual method accounts for the transaction as a sale of real estate, while the deposit method does not. The deposit method is the only method whereby disposition and financing by the seller does not result in a sale and corresponding recognition of a loan.

Banks may facilitate the sale of foreclosed real estate by requiring little or no down payment, or by offering loans with favorable terms. Profit shall only be recognized in full when the collectibility of the sales price is reasonably ensured and when the seller is not obligated to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit should be deferred. Collectibility of the sale price of OREO property is demonstrated when the buyer's investment is sufficient to ensure that the buyer will be motivated to honor his or her obligation to the seller rather than lose the investment. Collectibility shall also be assessed by considering factors such as the credit standing of the buyer, age and location of the property, and adequacy of cash flow from the property.

Bank records should (1) indicate the accounting method used for each sale of OREO, (2) support the choice of the method selected, and (3) sufficiently document that the institution is correctly reporting associated notes receivable, as either loans or OREO property, with valuation allowances when appropriate.

### *Full Accrual Method*

Under this method, the disposition of the real estate is recorded as a sale. The practice of

recognizing all profit from the sale of bank-financed OREO at the time of the sale is referred to as the full-accrual method. A bank shall not recognize profit using this method until all of the following general criteria are met:

- a sale is consummated,
- the buyer's initial and continuing investments adequately demonstrate a commitment to pay for the property,
- the bank's loan is not subject to future subordination,
- the bank has transferred to the buyer the usual risks and rewards of ownership, and
- the buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate the buyer's commitment to pay for the property.

A sale will not be considered consummated until the parties are bound by the terms of the contract, all consideration has been exchanged, and all conditions precedent to closing have been performed.

Initial investment, as defined within ASC 360-20-40, includes only cash down payments, notes supported by irrevocable letters of credit from an independent lending institution, payments by the buyer to third parties to reduce existing debt on the property, and other amounts paid by the buyer that are part of the sale price. In these situations, the standards require that profit on the sale be deferred until a minimum down payment has been received and annual payments equal those for a loan for a similar type of property with a customary amortization period. Payments must be sufficient to repay the loan over the customary term for the type of property. The amount of down payment required varies by property category: land, 20–25 percent; commercial and industrial, 10–25 percent; multifamily residential, 10–25 percent; and single-family residential, 5–10 percent. Ranges within these categories are defined further in the statement.

Continuing investment requires the buyer to be contractually obligated to make level annual payments on his or her total debt for the purchase price of the property. This level annual payment must be able to service principal and interest payments amortized for no more than 20 years for raw land, and for no more than the customary amortization term for a first-mortgage loan by an independent lending institution for other types of real estate. For example, the

customary repayment term for a loan secured by a single-family residential property could range up to 30 years.

### *The Installment Method*

This method is used when the buyer's down payment is insufficient to allow the full-accrual method, but when recovery of the cost of the property is reasonably assured if the buyer defaults. The installment method recognizes the sale of the property and the corresponding loan, although profits from the sale are recognized only as the bank receives payments from the buyer. Under this method, interest income is recognized on an accrual basis.

Since default on the loan usually results in the seller (the bank) reacquiring the real estate, the bank is reasonably assured that it will be able to recover its costs with a relatively small down payment. Cost recovery is especially likely when loans are made to buyers who have verifiable net worth, liquid assets, and income levels adequate to service the loan. Reasonable assurance of cost recovery also may be achieved when the buyer pledges adequate additional collateral.

### *The Cost-Recovery Method*

This method recognizes the sale of the property and the booking of the corresponding loan. This method may apply when dispositions do not qualify under the full accrual or installment methods. All income recognition is deferred. Principal payments are applied by reducing the loan balance, and interest payments are accounted for by increasing the unrecognized gross profit. No profit or interest income is recognized until either the buyer's aggregate payments exceed the recorded amount of the loan or a change to another accounting method (for example, the installment method) is appropriate. Consequently, the loan is maintained on nonaccrual status while this method is being used.

### *The Reduced Profit Method*

This method is used in certain situations when the sale of the real estate has not been consummated. The bank receives an adequate down payment, but the loan amortization schedule does not meet the requirements for use of the

full-accrual method. The bank again recognizes the sale of the property and the booking of the corresponding loan, but, as under the installment method, profits from the sale are recognized only as the bank receives payments from the buyer. Since sales with adequate down payments generally are not structured with inadequate loan-amortization schedules, this method is seldom used.

### *The Deposit Method*

This method is used when a sale of OREO has not been consummated. It also may be used for dispositions that could be accounted for under the cost-recovery method. Under this method, a sale is not recorded and the asset continues to be reported as OREO. Further, no profit or interest income is recognized. Payments received from the buyer are reported as a liability until sufficient payments or other events allow the use of one of the other methods.

## Nonrecourse Financing

Banks may promote the sale of foreclosed real estate by offering nonrecourse financing to buyers. These loans should be made under the same credit terms and underwriting standards the bank employs for its regular lending activity. Financing arrangements associated with this type of transaction are subject to the accounting treatment discussed above.

## CLASSIFICATION OF OREO

The examiner should generally evaluate the quality of each OREO property to determine if classification is appropriate. OREO usually should be considered a problem asset, even when it is carried at or below its appraised value. Despite the apparent adequacy of the fair or market value, the bank's acquisition of OREO through foreclosure usually indicates a lack of demand. As time passes, the lack of demand can become more apparent, and the value of the real estate can become increasingly questionable.

When evaluating the OREO property for classification purposes, the examiner must consider the property's fair value, whether it is being held in conformance with state law, and

whether it is being disposed of according to the bank's plan. The amount of an OREO property subject to classification is the carrying value of the property, net of any specific valuation allowance. The existence of a specific valuation allowance does not preclude adverse classification of OREO. The examiner should review all types of OREO for classification purposes, including sales that fail to meet the standards required for the full-accrual method of accounting. When the bank provides financing, the examiner should determine whether it is prudently underwritten.

The examiner should review all relevant factors to determine the quality and risk of the OREO property and the degree of probability that its carrying value will be realized. Some factors the examiner should consider include

- the property's carrying value relative to its fair value (including the date of any appraisal or evaluation relative to changes in market conditions), the bank's asking price, and offers received;
- the source and quality of the appraisal or evaluation, including the reasonableness of assumptions, such as projected cash flow for commercial properties;
- the length of time a property has been on the market and local market conditions for the type of property involved, such as history and trend of recent sales for comparable properties;
- bank management's ability and track record in liquidating other real estate and assets acquired in satisfaction of debts previously contracted;
- income and expenses generated by the property and other economic factors affecting the probability of loss exposure;
- the manner in which the bank intends to dispose of the property;
- other pertinent factors, including property-title problems, statutory redemption privileges, pending changes in the property's zoning, environmental hazards, other liens, tax status, and insurance.

## ENVIRONMENTAL LIABILITY

Under federal and state environmental liability statutes, a bank may be liable for cleaning up hazardous substance contamination of OREO. In some cases, the liability may arise before the bank takes title to a borrower's real estate collateral. A property's transition from collateral to bank ownership may take an extended period of time. As the financial problems facing a borrower worsen, a bank may become more involved in managing a company or property. Such involvement may become extensive enough that the bank is deemed to have met substantially all ownership criteria, the absence of a clear title in the bank's name notwithstanding. Generally, the more bank management is involved in such activity, the greater the bank's exposure to any future clean-up costs assessed in connection with the property. A more thorough discussion of environmental liability can be found in section 2040.1, "Loan Portfolio Management," of this manual, under the subsection "Other Lending Concerns."

# Other Real Estate Owned

## Examination Objectives

Effective date May 1995

## Section 2200.2

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1. To determine if the policies, practices, procedures, and internal controls regarding other real estate owned are adequate.
2. To determine that bank officers and employees are operating in conformance with the established guidelines.
3. To evaluate the validity and quality of all other real estate owned.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Other Real Estate Owned

## Examination Procedures

Effective date March 1984

## Section 2200.3

1. If selected for implementation, complete the Other Real Estate Owned section of the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures and obtain a listing of any audit deficiencies noted in the latest review done by internal/external auditors and determine if appropriate corrections have been made.
3. Obtain a list of other real estate owned and agree total to general ledger.
4. Review the other real estate owned account to determine if any property has been disposed of since the prior examination and:
  - a. If so, determine that:
    - The bank accepted written bids for the property.
    - The bids are maintained on file.
    - There is justification for accepting a lower bid if the bank did not accept the highest one.
  - b. Investigate any insider transactions.
5. Test compliance with applicable laws and regulations:
  - a. Determine that other real estate owned is held in accordance with the provisions of applicable state law.
  - b. Determine if other real estate is being amortized or written off in compliance with applicable state law.
  - c. Consult with the examiners assigned to “Loan Portfolio Management,” “Other Assets and Other Liabilities,” “Reserve for Possible Loan Losses” and “Bank Premises and Equipment” to determine if the situation holds real estate acquired as salvage on uncollectible loans, abandoned bank premises or property originally purchased for future expansion, which is no longer intended for such usage.
  - d. Review the details of all other real estate owned transactions to determine that:
    - The property has been booked at its fair value.
    - The documentation reflects the bank’s persistent and diligent effort to dispose of the property.
    - If the bank has made expenditures to improve and develop other real estate owned, proper documentation is in the file.
    - Real estate that is former banking premises has been accounted for as other real estate owned since the date of abandonment.
    - Such property is disposed of in accordance with state law.
6. Review parcels of other real estate owned with appropriate management personnel and, if justified, assign appropriate classification. Classification comments should include:
  - a. Description of property.
  - b. How real estate was acquired.
  - c. Amount and date of appraisal.
  - d. Amount of any offers and bank’s asking price.
  - e. Other circumstances pertinent to the classification.
7. Review the following with appropriate management personnel or prepare a memo to other examiners for their use in reviewing with management:
  - a. Internal control exceptions and deficiencies in, or non-compliance with, written policies, practices and procedures.
  - b. Uncorrected audit deficiencies.
  - c. Violations of law.
8. Prepare comments in appropriate report form for all:
  - a. Criticized other real estate owned.
  - b. Deficiencies noted.
  - c. Violations of law.
9. Update the workpapers with any information that will facilitate future examinations.

# Other Real Estate Owned Internal Control Questionnaire

Effective date March 1984

## Section 2200.4

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Review the bank's internal controls, policies, practices and procedures for other real estate owned. The bank's systems should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

### RECORDS

1. Is the preparation, addition, and posting of subsidiary other real estate owned records performed and/or tested by persons who do not have direct, physical or accounting, control of those assets?
2. Are the subsidiary other real estate owned records balanced at least annually to the appropriate general ledger accounts by persons who do not have direct, physical or accounting, control of those assets?
3. Is the posting to the general ledger other real estate owned accounts approved, prior to posting, by persons who do not have direct, physical or accounting, control of those assets?
4. Are supporting documents maintained for all entries to other real estate owned accounts?
5. Are acquisitions and disposals of other real estate owned reported to the board of directors or its designated committee?

6. Does the bank maintain insurance coverage on other real estate owned including liability coverage where necessary?
7. Are all parcels of other real estate owned reviewed at least annually for:
  - a. Current appraisal or certification?
  - b. Documentation inquiries and offers?
  - c. Documented sales efforts?
  - d. Evidence of the prudence of additional advances?

### OTHER PROCEDURES

8. Are the bank's policies and procedures relating to the real estate owned in writing?

### CONCLUSION

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

### OTHER ASSETS

The term *other assets*, as used in this section, includes all balance-sheet asset accounts not covered specifically in other areas of the examination. Often, such accounts may be quite insignificant in the overall financial condition of the bank. However, significant subquality assets may be uncovered in banks lacking proper internal controls and procedures.

In many banks, other asset accounts are maintained on the daily statement but must be reflected in a specific asset category for reporting. Schedule RC-F of the Consolidated Report of Condition lists the specific accounts classified as “other assets” and includes a catchall heading of “other.” Certain accounts in that other asset account, such as securities borrowed, are examined using the procedures described in the appropriate section of this manual.

#### Types of Other Asset Accounts

Types of other assets frequently found in banks are the various temporary holding accounts, such as suspense, interoffice, teller, transit, and bookkeeping differences having debit balances. Those accounts should be used only for temporary recording until the offsetting entry is received or fully identified and posted to the proper account. A bank should have written internal control procedures to ensure that difference accounts are reconciled and closed out on a timely basis. Nothing should be allowed to remain in those accounts for any significant length of time—usually no more than a few business days. All difference accounts should be closed out at least quarterly.

General categories of other assets common to banks are accrued interest receivables (on loans, debt securities, and other interest-bearing assets) and other types of income earned but not yet collected (income derived from an asset that is recognized but not yet collected or received on the reporting date), net deferred tax assets (deferred tax assets less deferred tax liabilities that result in a debit balance for a particular tax jurisdiction), interest-only strips receivables for mortgage loans and other financial assets, pre-paid expenses (cash outlays for goods and services, the benefits of which will be realized in

future periods), equity securities (cost of) that do not have readily determinable fair values (including Federal Reserve stock and bankers’ bank stock), the cash surrender value of bank-owned life insurance (BOLI), and other nonsecurity or other interest-only strips receivables.

An interest-only strip receivable is the contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation, or other interest-bearing financial asset. This includes, for example, the contractual rights to future interest cash flows that exceed contractually specified servicing fees on financial assets that have been sold.

The other assets category also consists of unique and unusual transactions that are not appropriate to include in other line items of a bank’s balance sheet. An unlimited number of possible account titles could be included in this category, such as redeemed food stamps, art objects, antiques, and coin and bullion. Regardless, the examiner must design specific procedures for review and testing to fit the particular account and situation and must document the scope of the review in the workpapers.

#### Examination Review of Other Assets

Examiners assigned to “other assets” must obtain the detailed breakdown of these accounts when they are reported on the bank’s statement of condition and when they are so designated for the purposes of reporting on the bank’s Call Report. When the account can best be examined by examiners assigned to other areas of the bank, the detailed breakdown of the accounts should be furnished to those examiners. The remaining accounts should be reviewed and evaluated by examiners assigned to this section. The major factor in deciding which accounts are to be reviewed are materiality and the volume of transactions flowing through the account.

With regard to materiality, the examiner should evaluate whether to analyze the nature and quality of each individual item, on the basis of its impact on the overall soundness of the bank or the quality of the bank’s earnings. Therefore, the examiner needs to verify—

- the existence of the asset;
- the proper valuation of the asset;



- that the asset is properly classified, described, and disclosed in the financial statements (including the existence of any liens);
- that the asset is being properly amortized on a consistent basis over the estimated period of benefit;
- that any sales of assets, including the recognition of gains and losses, have been properly recognized; and
- the adequacy of the accounting and disposition controls for, as well as the quality of, the asset.

With regard to transaction volume, the examiner should evaluate whether any accounts with small balances have an unusually high level of transaction volume. Therefore, it is important that the examiner verify that—

- the account has a valid business purpose,
- the account is reconciled on a regular basis, and
- the accounting controls are adequate.

An examiner should authenticate the existence of the selected assets by ensuring that their supporting documentation is adequate. Also, the examiner should verify that ownership of the asset rests with the bank. (In the case of organizational costs borne by the bank for the formation of a holding company, those costs, and the related ownership rights in the capitalized asset, should more properly be borne by the ownership interests and should not be recorded as assets of the bank.)

Proper valuation and reporting of other asset accounts is another potential area of concern for the examiner. Assets are generally acquired through purchase, trade, repossession, prepayment of expenses, or accrual of income. Generally, assets purchased, traded, or repossessed are transferred at their fair market value. Prepaid expenses and income accrued are booked at cost. An examiner should be particularly alert in identifying those assets that lose value over time to ensure that they are appropriately depreciated or amortized. All intangible assets should be regularly amortized, and management should have a system in place to confirm the valuation of the remaining book balance of the intangible assets.

The examiner needs to ensure that the controls concerning other assets protect the bank's ownership rights, the accounts are properly valued and accurately reported, and control

activities are monitored regularly by management. A bank with good control and review procedures will periodically charge off all uncollectible or unreconcilable items. However, the examiner must frequently go beyond the general ledger control accounts and scan the underlying subsidiary ledgers to ensure that posting errors and the common practice of netting certain accounts against each other do not cause significant balances to go unnoticed because of lack of proper detail.

## Deferred Tax Assets

For verifying compliance with the limits found in the risk-based capital guidelines, examiners need to review the net deferred tax assets (deferred tax assets less deferred tax liabilities) that a bank reports in its regulatory reports and the amount of limited deferred tax assets that are not deducted from a bank's tier 1 capital. The net deferred taxes result from the application of an asset and liability approach for financial-accounting and reporting for income taxes. Net deferred taxes (net deferred tax assets) generally arise from the tax effects of reporting income or expense charges in one period for financial-statement purposes and in another period for tax purposes. This effect, known as a temporary difference, is at times sizable. Tax laws often differ from the recognition and measurement requirements of financial accounting standards. Differences can arise between (1) the amount of taxable income and pretax financial income for a year and (2) the tax bases of assets or liabilities and their reported amounts in financial statements. Charges that result in a significant deferred tax asset are often caused by loan-loss provisions exceeding bad debt deductions for tax purposes in a given period. While banks are permitted to carry deferred income tax assets on their reports of condition, they are limited by generally accepted accounting principles (GAAP) to the extent these items can be carried.

The Financial Accounting Standards Board's (FASB) Statement No. 109 (FAS 109), "Accounting for Income Taxes," establishes procedures to (1) measure deferred tax assets and liabilities using a tax-rate convention and (2) assess whether a valuation allowance should be established for deferred tax assets. Enacted tax laws and rates are considered in determining the applicable tax rate and in assessing the need for

a valuation allowance. FAS 109 was to be adopted by banks as of January 1, 1993, or the beginning of their first fiscal year thereafter, if later.

FAS 109 requires a deferred tax asset to be recognized for all temporary differences that will result in deductible amounts in future years and for tax credit carryforwards. For example, a temporary difference may be created between the reported amount and the tax basis of a liability for estimated expenses if, for tax purposes, those estimated expenses are not deductible until a future year. Settlement of that liability will result in tax deductions in future years, and a deferred tax asset is recognized in the current year for the reduction in taxes payable in future years. A valuation allowance is recognized (deducted from the amount of the deferred tax asset) if, based on the weight of available evidence, it is *likely* that some or all of the deferred tax asset will not be realized.

### *Deferred Tax Liabilities*

A deferred tax liability is recognized for temporary differences that will result in taxable amounts in future years. Deferred tax liabilities that may be related to a particular tax jurisdiction (for example, federal, state, or local) may be offset against each other for reporting purposes. A resulting debit balance is included in “other assets” on the bank Call Report and reported in Schedule RC-F; a resulting credit balance is included in “other liabilities” on the bank Call Report and reported in Schedule RC-G. A bank may report a net deferred tax debit (or asset) for one tax jurisdiction (for example, federal taxes) and also report a net deferred tax credit (or liability) for another tax jurisdiction (for example, state taxes).

### *Limitation on Deferred Tax Assets for Tier 1 Risk-Based Capital and Leverage Capital*

The risk-based capital and leverage capital guidelines include a limit on the amount of certain deferred tax assets that may be included in (that is, not deducted from) tier 1 capital for determining the amount of the bank’s required risk-based and leverage capital levels. Certain deferred tax assets can only be realized if a bank earns taxable income in the future. Deferred tax

assets are limited, for regulatory capital purposes, to (1) the amount that the bank expects to realize within one year of the quarter-end report date (based on its projections of future taxable income for that year) or (2) 10 percent of tier 1 capital, whichever is less. The reported amount of deferred tax assets, net of any valuation allowance for deferred tax assets, in excess of the lesser of these two amounts is to be deducted from a bank’s core capital elements in determining tier 1 capital. See section 3020.1 for more detailed information on how to determine the capital composition and limitation on deferred tax assets.

### **Bank-Owned Life Insurance to Be Included in Other Assets**

FASB’s Technical Bulletin No. 85-4 (FTB 85-4), “Accounting for the Purchases of Life Insurance,” addresses the accounting for BOLI. “Other assets” are to include the amount of the assets that represent the cash surrender value of the insurance policy that is reported to the institution by the insurance carrier (less any applicable surrender charges not reflected by the insurance carrier in the reported cash surrender value that could be realized under the insurance contract) as of the balance-sheet date. Because there is no right of offset, an investment in BOLI is reported as an asset separately from any deferred compensation liability. BOLI is reported on the balance sheet of the bank Call Report as “other assets” and on its schedule RC-F as “all other assets—cash surrender value of life insurance.” (See SR-04-4 and SR-04-19.) (The net earnings (losses) on, or the net increases (decreases) in, the net cash surrender value of BOLI should be reported according to the bank Call Report instructions for the glossary and the income statement, Schedules RI and RI-E.)

## **OTHER LIABILITIES**

The term *other liabilities* represents the bank’s authorized obligations. Other liabilities, as used in this section, include all balance-sheet liability accounts not covered specifically in other areas of the examination. The accounts often may be quite insignificant when compared with the overall size of the bank. In some banks, individual accounts are established for control pur-

poses and appear on the balance sheet as “other liabilities.” For reporting, however, these accounts must be assigned to specific liability categories or netted from related asset categories, as appropriate.

Schedule RC-G of the Consolidated Report of Condition lists the specific accounts classified as “other liabilities.” The schedule includes interest accrued and unpaid on deposits and other expenses that are accrued and unpaid (including accrued income taxes payable), net deferred tax liabilities, the allowance for credit losses on off-balance-sheet credit exposures, and all other liabilities. “All other liabilities” includes liability accounts such as accounts payable, deferred compensation liabilities, dividends that are declared but not yet payable, and derivatives with a negative fair value held for purposes other than trading.

As stated above, the “all other liabilities” term includes deferred compensation liabilities. This account is used to record the bank’s obligation under its deferred compensation agreements. Section 3015.1 discusses deferred compensation agreements in detail, both as to the nature and operation of the different types of agreements and the accounting standards and guidance that are applicable to those agreements—in particular, a revenue-neutral plan or an indexed retirement plan. (See also SR-04-4, SR-04-19, and the glossary entry for “deferred compensation agreements” in the bank Call Report instructions.)

## Types of Other Liability Accounts

A general category of other liabilities common to banks is expenses accrued and unpaid. These accounts represent periodic charges to income based on anticipated or contractual payments of funds to be made at a later date. They include such items as interest on deposits, dividends, taxes, and expenses incurred in the normal course of business. There should be a correlation between the amount being accrued daily or monthly and the amount due on the stated or anticipated payment date.

Other liability accounts should be reviewed to determine that accounts, such as deferred taxes, are being properly recognized when there are temporary differences in the recognition of income and expenses between the books and the income tax returns. This review should also

determine that matters such as pending tax litigation, equipment contracts, and accounts payable have been properly recorded and are being discharged in accordance with their terms and requirements.

Various miscellaneous liabilities may be found in accounts, such as undisbursed loan funds, deferred credits, interoffice, suspense, and other titles denoting pending status. An unlimited number of possible items could be included. The review of these accounts should determine that they are used properly and that all such items are clearing in the normal course of business. Because of the variety of such accounts, the examiner must develop specific examination procedures to fit the particular account and situation.

## Examination Review of Other Liabilities

Examiners assigned to “other liabilities” are responsible for obtaining the bank’s breakdown of these accounts and, when the accounts are to be examined under other sections, must ensure that examiners in charge of those sections receive the necessary information. The remaining accounts should be reviewed and evaluated by examiners assigned to this section.

The primary emphasis of examining other liabilities is to obtain reasonable assurance that (1) the liabilities represent the bank’s authorized obligations and (2) all contingencies and estimated current-period expenses that will be paid in future periods that should be accrued during the period have been accrued, classified, and described in accordance with GAAP, and the related disclosures are adequate. Another emphasis in examining this area should be the adequacy of the controls and procedures the bank employs to promptly record the amount of liability. Without proper management attention, these accounts may be advertently or inadvertently misstated. Unless properly supervised, these accounts may be used to conceal shortages that should be detected immediately. For instance, other liabilities may include fraudulent entries for suspense or interbranch accounts that could be rolled over every other day to avoid stale dates, causing shortages of any amount to be effectively concealed for indefinite periods of time.

Similar to “other assets,” other liability

accounts with small balances may be significant. Scanning account balances may disclose a recorded liability, but it does not aid in determining the accuracy of liability figures. Therefore, it is important to review the documented information obtained from examiners working with and reviewing the minutes of the board and

its committees. Responses from legal counsel handling litigation could also be important because this information might reveal a major understatement of liabilities. Determining accurate balances in other liability accounts requires an in-depth review of source documents or the other accounts in which the liability arose.

# Other Assets and Other Liabilities

## Examination Objectives

Effective date May 1993

## Section 2210.2

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1. To determine if policies, practices, procedures, and internal controls regarding “other assets” and “other liabilities” are adequate.
2. To determine that bank officers and employees are operating in conformance with established guidelines.
3. To evaluate the validity and quality of all “other assets.”
4. To determine that “other liabilities” are properly recorded.
5. To determine the scope and adequacy of the audit function.
6. To determine compliance with laws and regulations.
7. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

# Other Assets and Other Liabilities

## Examination Procedures

Effective date May 1993

## Section 2210.3

1. Complete or update the Internal Control Questionnaire, if selected for implementation.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if appropriate corrections have been made.
4. Obtain from the examiner assigned "Examination Strategy" the list of "other assets" and "other liabilities" accounts.
5. Obtain a trial balance of "other assets" and "other liabilities" accounts, including a detailed listing of the interbank accounts and:
  - a. Agree or reconcile balances to department controls and general ledger.
  - b. Review reconciling items for reasonableness.
6. Scan the trial balances for:
  - a. Obvious misclassifications of accounts and, if any are noted, discuss reclassification with appropriate bank personnel and furnish a list to appropriate examining personnel.
  - b. Large, old, or unusual items and, if any are noted, perform additional procedures as deemed appropriate, being certain to appraise the quality of "other assets."
  - c. "Other assets" items that represent advances to related organizations, directors, officers, employees, or their interests, and if any are noted, inform the examiner assigned "Loan Portfolio Management."
7. Determine that amortizing "other assets" accounts are being amortized over a reasonable period correlating to their economic life.
8. If the bank has outstanding customer liability under letters of credit, obtain and forward a list of the names and amounts to the examiner assigned "Loan Portfolio Management."
9. Review the balance of any "other liabilities" owed to officers, directors, or their interests and investigate, by examining applicable supporting documentation, whether they have been used—
  - a. record unjustified amounts; or
  - b. record amounts for items unrelated to bank operations.
10. Develop, and note in the workpapers, any special programs considered necessary to properly analyze any remaining "other assets" or "other liabilities" account.
11. Test for compliance with applicable state laws and regulations.
12. For "other assets" items that are determined to be stale, abandoned, uncollectible, or carried in excess of estimated values, and for "other liabilities" items that are determined to be improperly stated, after consulting with the examiner-in-charge, request management to make the appropriate entries on the bank's books.
13. Prepare, in appropriate report form, and discuss with appropriate officer(s):
  - a. Violations of laws and regulations.
  - b. Criticized "other assets."
  - c. The adequacy of written policies relating to "other assets" and "other liabilities."
  - d. Recommended corrective action when policies, practices, or procedures are deficient.
14. Update the workpapers with any information that will facilitate future examinations.

# Other Assets and Other Liabilities

## Internal Control Questionnaire

Effective date May 1993

## Section 2210.4

Review the bank's internal controls, policies, practices, and procedures concerning "other assets" and "other liabilities." The bank's systems should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

9. Are receivables reviewed at least quarterly for collectibility by someone other than the originator of the entry?
10. Is approval required to pay credit balances in receivable accounts?
11. Do credit entries to a receivables account, other than payments, require the approval of an officer independent of the entry preparation?

### OTHER ASSETS

#### Policies and Procedures

1. Has the bank formulated written policies and procedures governing "other assets" accounts?

#### Records

2. Is the preparation of entries and posting of subsidiary "other assets" records performed or tested by persons who do not also have direct control, either physical or accounting, of the related assets?
3. Are the subsidiary "other assets" records, if any, balanced at least quarterly to the appropriate general ledger accounts by persons who do not also have direct control, either physical or accounting, of the related assets?
4. Is the posting of "other assets" accounts to the general ledger approved prior to posting by persons who do not also have direct control, either physical or accounting, of the related assets?
5. Are worksheets or other supporting records maintained to support prepaid expense amounts?
6. Are supporting documents maintained for all entries to "other assets"?
7. Are the items included in suspense accounts aged and reviewed for propriety regularly by responsible personnel?

#### Receivables

8. Are receivables billed at regular intervals? (If so, state frequency \_\_\_\_\_.)

#### Other Procedures

12. Does charge-off of a nonamortizing "other asset" initiate review of the item by a person not connected with entry authorization or posting?
13. Do review procedures, where applicable, provide for an appraisal of the asset to determine the propriety of the purchase or sale price?

#### Conclusion

14. Does the foregoing information provide an adequate basis for evaluating internal controls in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
15. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?

### OTHER LIABILITIES

#### Policies and Procedures

1. Has the bank formulated written policies and procedures governing the "other liabilities" accounts?

#### Records

2. Does the bank maintain subsidiary records of items comprising "other liabilities"?

3. Is the preparation of entries and posting of subsidiary "other liabilities" records performed or tested by persons who do not also originate or control supporting data?
4. Are subsidiary records of "other liabilities" balanced at least monthly to appropriate general ledger accounts by persons who do not also originate or control supporting data?
5. Are the items included in suspense accounts aged and reviewed for propriety regularly by responsible personnel?
10. Are invoices and bills verified and approved by designated employees prior to payment?
11. Are procedures established to call attention, within the discount period, to invoices not yet paid?
12. Does the bank have a system of advising the board of directors of the acquisition and status of major "other liabilities" items?
13. Are all payroll tax liabilities agreed to appropriate tax returns and reviewed by an officer to ensure accuracy?

### Other Procedures

6. Does the bank book obligations immediately on receipt of invoices or bills for services received?
7. If the bank uses a Federal Reserve deferred credit account, is the liability for incoming "Fed" cash letters booked immediately upon receipt?
8. Does the bank book dividends that have been declared but are not yet payable?
9. Are invoices and bills proved for accuracy prior to payment?

### Conclusion

14. Does the foregoing information provide an adequate basis for evaluating internal controls in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
15. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?



Deposits are funds that customers place with a bank and that the bank is obligated to repay on demand, after a specific period of time or after expiration of some required notice period. Deposits are the primary funding source for most banks and, as a result, have a significant effect on a bank's liquidity. Banks use deposits in a variety of ways, primarily to fund loans and investments. Management should establish a procedure for determining the volatility and composition of the deposit structure to ensure that funds are employed profitably, while allowing for their potential withdrawal. Therefore, a bank's management should implement programs to retain and prudently expand the bank's deposit base.

Bankers place great significance on the deposit structure because favorable operating results depend, in part, on a core deposit base. Because of competition for funds, the need for most individuals and corporations to minimize idle funds, and the effect of disintermediation (the movement of deposits to other higher-yielding markets) on a bank's deposit base, bank management should adopt and implement a development and retention program for all types of deposits.

### DEPOSIT DEVELOPMENT AND RETENTION PROGRAM

Important elements of the examination process are the review of a bank's deposit development and retention program and the methods used to determine the volatility and composition of the deposit structure. A bank's deposit development and retention program should include—

- a marketing strategy,
- projections of deposit structure and associated costs, and
- a formula for comparing results against projections.

To structure a deposit program properly, bank management must consider many factors, some of which include—

- the composition of the market-area economic base,
- the ability to employ deposits profitably,

- the adequacy of current operations (staffing and systems) and the location and size of banking quarters relative to the bank's volume of business,
- the degree of competition from banks and nonbank financial institutions and their programs to attract deposit customers, and
- the effects of the national economy and the monetary and fiscal policies of the federal government on the bank's service area.

The bank's size and the composition of its market determine how formal its deposit program should be. After a bank develops its deposit program, management must continue to monitor the above factors and correlate any findings to determine if adjustments are needed. The long-term success of any deposit program relates directly to the ability of management to make adjustments at the earliest possible time.

### DEPOSIT STRUCTURE

Management should look not only at deposit growth but also at the nature of the deposit structure. To invest deposited funds properly in view of anticipated or potential withdrawals, management must be able to determine what percentage of the overall deposit structure is centered in core deposits, in fluctuating or seasonal deposits, and in volatile deposits. It is important that internal reports with information concerning the composition of the deposit structure be provided to management periodically. Management's lack of such knowledge could lead to an asset-liability mismatch, causing problems at a later date.

In analyzing the deposit structure, information gathered by the various examination procedures should be sufficient to allow the examiner to evaluate the composition of both volatile and core deposits. Ultimately, the examiner should be satisfied with management's efforts to plan for the bank's future.

Examiners must analyze the present and potential effect deposit accounts have on the financial condition of the bank, particularly with regard to the quality and scope of management's planning. The examiner's efforts should be directed to the various types of deposit accounts that the bank uses for its funding base. The

examiners assigned to the areas of funds management and to the analytical review of the bank's income and expenses should be informed of any significant change in interest-bearing deposit-account activity.

## COST OF FUNDS

Interest paid on deposits is generally the largest expense to a bank. As a result, interest-bearing deposit accounts employed in a marginally profitable manner could have significant and lasting effects on bank earnings. The examiner should consider the following in evaluating the effect of interest-bearing deposit accounts on a bank's earnings:

- an estimated change in interest expense resulting from a change in interest rates on deposit accounts or a shift in funds from one type of account to another
- service-charge income
- projected operating costs
- changes in required reserves
- promotional and advertising costs
- the quality of management's planning

## SPECIAL DEPOSIT-RELATED ISSUES

The examiner should keep the following issues in mind during an examination to ensure the bank is in compliance, where applicable.

### Abandoned-Property Law

State abandoned-property laws generally are called escheat laws. Although escheat laws vary from state to state, they normally require a bank to remit the proceeds of any deposit account to the state treasurer when—

- the deposit account has been dormant for a certain number of years and
- the owner of the account cannot be located.

Service charges on dormant accounts should bear a direct relationship to the cost of servicing the accounts, which ensures that the charges are not excessive. A bank's board of directors (or a committee appointed by the board) should review

the basis on which service charges on dormant accounts are assessed and should document the review. There have been occasions when excessive servicing charges have resulted in no proceeds being remitted at the time the account became subject to escheat requirements. In these cases, courts have required banks to reimburse the state. (See also the "Dormant Accounts" discussion later in this section.)

### Bank Secrecy Act

Examiners should be aware of the Bank Secrecy Act when examining the deposit area and should follow up on any unusual activities or arrangements noted. The act was implemented by the Treasury Department's Financial Recordkeeping and Reporting of Currency and Foreign Transactions Regulation. For further information, see the *FFIEC Bank Secrecy Act Examination Manual*, section 208.63 of the Federal Reserve's Regulation H, and the Financial Crimes Enforcement Network (FinCEN)'s Bank Secrecy Act regulations at 31 CFR Chapter X. Prior to March 1, 2011, FINCEN's regulation was at 31 CFR 103. (See SR-11-4 and its interagency attachment.)

### Banking Hours and Processing of Demand Deposits

The Board's Regulation CC (12 CFR 229), "Availability of Funds and Collection of Checks," and the Uniform Commercial Code (UCC) govern banking-day cutoff hours and the processing of deposits. A "banking day" is that part of a day on which an office of the bank is open to the public for carrying out substantially all of its banking functions. Saturdays, Sundays, and certain specified holidays are not banking days under Regulation CC, although such days might be banking days under the UCC if a bank is open for substantially all of its functions on those days.

Regulation CC requires a bank to make deposited funds available for withdrawal within a certain period after the banking day on which they are received. Cash deposits, wire transfers, and certain check deposits that pose little risk to the depository bank (such as Treasury checks and cashier's checks) generally are to be made available for withdrawal by the business day

after the day of deposit. The time when the depository bank must make other check deposits available for withdrawal depends on whether the check is local or nonlocal to the depository bank. As of September 1, 1990, proceeds of local and nonlocal checks must be available for withdrawal by the second and fifth business day following deposit, respectively. However, Regulation CC allows a bank to set, within certain limits, cutoff hours, after which the bank will deem funds to be received on the next banking day for purposes of calculating the availability date (12 CFR 229.19). Different cutoff-hour limits apply to different types of deposits.

For the purpose of allowing banks to process checks, the UCC provides that a bank may set a cutoff hour of 2 p.m. or later and that items received after that time will be considered received as of the next banking day (UCC section 4-108). Under both the UCC and Regulation CC, both the banking day on which a bank is deemed to have received a check and the cutoff hour affect the time frames within which a bank must send the check through the forward-collection and return processes.

A bank that fails to set its cutoff hour appropriately, does not make funds available within the appropriate time frames, or processes checks in an untimely manner may be subject to civil liability for not performing its duties in accordance with various provisions of Regulation CC and the UCC.

### Banking Accounts for Foreign Governments, Embassies, Missions, and Political Figures

On June 15, 2004, an interagency advisory concerning the embassy banking business and related banking matters was issued by the federal banking and thrift agencies (the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration (the agencies)). The advisory was issued in coordination with the U.S. Department of the Treasury's Financial Crimes Enforcement Network. The purpose of the advisory is to provide general guidance to banking organizations regarding the treatment of accounts for foreign governments, foreign embassies, and foreign political figures.

The joint interagency statement advises banking organizations that the decision to accept or reject an embassy or foreign government account is theirs alone to make. The statement advises that financial institutions should be aware that there are varying degrees of risk associated with such accounts, depending on the customer and the nature of the services provided. Institutions should take appropriate steps to manage such risks consistent with sound practices and applicable anti-money-laundering laws and regulations. The advisory also encourages banking organizations to direct questions about embassy banking to their primary federal bank regulators. (See SR-04-10.)

On March 24, 2011, an interagency advisory was issued to supplement SR-04-10, "Banking Accounts for Foreign Governments, Embassies, and Political Figures." The supplemental advisory provides information to financial institutions regarding the provision of account services to foreign embassies, consulates and to foreign missions in a manner that fulfills the needs of those foreign governments while complying with the provisions of the Bank Secrecy Act (BSA). It advises that financial institutions are expected to demonstrate the capacity to conduct appropriate risk assessments and implement the requisite controls and oversight systems to effectively manage the risk identified in these relationships with foreign missions. The advisory also confirms that it is the financial institution's decision to accept or reject a foreign mission account. (See SR-11-6 and the attached supplemental interagency advisory.)

#### *Interagency Advisory on Accessing Accounts from Foreign Governments, Embassies, and Foreign Political Figures*

The 2004 interagency advisory answers questions on whether financial institutions should conduct business with foreign embassies and whether institutions should establish account services for foreign governments, foreign embassies, and foreign political figures. As it would with any new account, an institution should evaluate whether or not to accept a new account for a foreign government, embassy, or political figure. That decision should be made by the institution's management, under standards and guidelines established by the board of directors, and should be based on the institution's own business objectives, its assessment of the risks

associated with particular accounts or lines of business, and its capacity to manage those risks. The agencies will not, in the absence of extraordinary circumstances, direct or encourage any institution to open, close, or refuse a particular account or relationship.

Providing financial services to foreign governments and embassies and to foreign political figures can, depending on the nature of the customer and the services provided, involve varying degrees of risk. Such services can range from account relationships that enable an embassy to handle the payment of operational expenses, for example, payroll, rent, and utilities, to ancillary services or accounts provided to embassy staff or foreign government officials. Each of these relationships potentially poses different levels of risk. Institutions are expected to assess the risks involved in any such relationships and to take steps to ensure both that such risks are appropriately managed and that the institution can do so in full compliance with its obligations under the BSA, as amended by the USA Patriot Act, and the regulations promulgated thereunder.

When an institution elects to establish financial relationships with foreign governments, embassies, or foreign political figures, the agencies, consistent with their usual practice of risk-based supervision, will make their own assessment of the risks involved in such business. As is the case with all accounts, the institution should expect appropriate scrutiny by examiners that is commensurate with the level of risk presented by the account relationship. As in any case where higher risks are presented, the institution should expect an increased level of review by examiners to ensure that the institution has in place controls and compliance oversight systems that are adequate to monitor and manage such risks, as well as personnel trained in the management of such risks and in the requirements of applicable laws and regulations.

Institutions that have or are considering taking on relationships with foreign governments, embassies, or political figures should ensure that such customers are aware of the requirements of U.S. laws and regulations to which the institution is subject. Institutions should, to the maximum extent feasible, seek to structure such relationships in order to conform them to conventional U.S. domestic banking relationships so as to reduce the risks that might be presented by such relationships.

## Foreign-Currency Deposits

Domestic depository institutions are permitted to accept deposits denominated in foreign currency. Institutions should notify customers that such deposits are subject to foreign-exchange risk. The bank should convert such accounts to the U.S. dollar equivalent for purposes of reporting to the Federal Reserve. Examination staff should ascertain that all reports are in order and should evaluate the bank's use of such funds and its management of the accompanying foreign-exchange risk. Accounts denominated in foreign currency are not subject to the requirements of Regulation CC. (See SR-90-03 (IB), "Foreign (Non-U.S.) Currency Denominated Deposits Offered at Domestic Depository Institutions.")

## International Banking Facilities

An international banking facility (IBF) is a set of asset and liability accounts segregated on the books of a depository institution. IBF activities are essentially limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institutions establishing the IBF. IBFs are not required to maintain reserves against their time deposits or loans. The examiner should follow the special examination procedures in the international section of this manual when examining an IBF.

## Deposits Insured by the Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation (FDIC) is an independent agency of the U.S. government. The FDIC protects depositors against the loss of their insured deposits due to the failure of an insured bank, savings bank, savings association, insured branch of a foreign bank, or other depository institution whose deposits are insured pursuant to the Federal Deposit Insurance Corporation Act. If a depositor's accounts at one FDIC-insured depository institution total up to \$250,000 (or the standard maximum deposit insurance amount [SMDIA]), the funds are fully insured and protected. A depositor can have more than the SMDIA at one insured depository institution and still be fully insured provided the accounts meet certain requirements. In addition, federal law currently

provides for insurance coverage of up to \$250,000 or the SMDIA.

The FDIC insurance covers all types of deposits received at an insured depository institution, including deposits in checking, negotiable order of withdrawal (NOW), and savings accounts; money market deposit accounts; and time deposits such as certificates of deposit (CDs). FDIC deposit insurance covers the balance of each depositor's account, dollar-for-dollar, up to the SMDIA, including the principal and any accrued interest through the date of an insured depository institution's closing.

Deposits in separate branches of an insured depository institution are not separately insured. Deposits in one insured institution are insured separately from deposits in another insured institution. Deposits maintained in different categories of legal ownership at the same depository institution can be separately insured. Therefore, it is possible to have deposits of more than the SMDIA at one insured institution and still be fully insured.

## Deposit Insurance Reform Acts

On March 14, 2006, the FDIC amended its deposit insurance regulations (effective April 1, 2006) by issuing an interim rule with a request for public comment on or before May 22, 2006. (See 71 *Fed. Reg.* 14631, 71 *Fed. Reg.* 53550 (Sept. 12, 2006) and 12 CFR Part 330.) The interim rule implemented applicable revisions to the Federal Deposit Insurance Act made by the Federal Deposit Insurance Reform Act of 2005 (Reform Act) and the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (the Conforming Amendments Act). The Reform Act provided for consideration of inflation adjustments (cost-of-living adjustment) to increase the current SMDIA on a five-year cycle beginning on April 1, 2010.

Second, the Reform Act increased the deposit insurance limit for accounts up to \$250,000, also subject to inflation adjustments. The types of accounts included are individual retirement accounts (IRAs),<sup>1</sup> eligible deferred compensation plan accounts,<sup>2</sup> and individual account plan

accounts,<sup>3</sup> and any plan described in section 401(d) of the IRC, to the extent that participants and beneficiaries under such plans have a right to direct the investment of assets held in individual accounts maintained on their behalf by the plans.

Third, the Reform Act provided per-participant insurance coverage to employee benefit plan accounts, even if the depository institution at which the deposits are placed is not authorized to accept employee benefit plan deposits. The cost-of-living adjustment is to be calculated according to the Personal Consumption Expenditures Chain-type Price Index published by the U.S. Department of Commerce and rounded down to the nearest \$10,000.

The Conforming Amendments Act created the term *government depositor* in connection with public funds described in and insured pursuant to section 11(a)(2) of the Federal Deposit Insurance Act (FDIA). (See 12 USC 1821(a)(2).) The Conforming Amendments Act provides that the deposits of a government depositor are insured in an amount up to the SMDIA, subject to the inflation adjustment described previously.

## Deposit Insurance Rule Amendments

### *Retirement and Employee Benefit Plan Accounts*

When deposits from a retirement or employee benefit plan (EBP)—such as a 401(k) retirement account, Keogh plan account, corporate pension plan, or profit-sharing program—are entitled to pass-through insurance, the SMDIA on FDIC insurance does not apply to the entire EBP account balance. Rather, the FDIC insurance coverage “passes through” to each owner or beneficiary, and the deposited funds of each individual EBP participant are insured up to the SMDIA.

The Reform Act and the Conforming Amendments Act, and the FDIC's March 23, 2006, interim rule eliminated the previous requirement that pass-through coverage for employee benefit plan accounts be dependent on the capital level of a depository institution where such deposits are placed. Pass-through coverage for employee benefit plan deposits was not available if the

1. IRAs described in section 408(a) of the Internal Revenue Code (IRC). (See 26 USC 408(a).)

2. Eligible deferred compensation plan accounts described in section 457 of the IRC. (See 26 USC 457.)

3. Individual account plan accounts such as those defined in section 3(34) of the Employee Retirement Income Security Act.



deposits were placed with an institution that was not permitted to accept brokered deposits because of the capital requirements. Insured institutions that are not “well capitalized” or “adequately capitalized” are now prohibited by the Reform Act from accepting employee benefit plan deposits. Under the Reform Act, employee benefit plan deposits accepted by an insured depository institution, even those prohibited from accepting such deposits, are nonetheless eligible for pass-through deposit insurance coverage. The rule’s amendment (see 12 CFR 330.14) applies to all employee benefit plan deposits, including employee benefit plan deposits placed before April 1, 2006. The rule’s other requirements in section 330.14 continue to apply. In particular, only the “noncontingent” interests of plan participants in an applicable plan are eligible for pass-through coverage. A “noncontingent interest” is an interest that can be determined without the evaluation of contingencies other than life expectancy. The maximum coverage for accounts is up to \$250,000 or the SMDIA. These accounts continue to be made up of individual retirement accounts (the traditional IRAs and the Roth IRAs); section 457 deferred compensation plan accounts, “self-directed” Keogh plan accounts (or HR 10 accounts); and “self-directed” defined contribution plan accounts, which are primarily 401(k) plan accounts. The term *self-directed* means that the plan participants have the right to direct how their funds are invested, including the ability to direct that the funds be invested at an FDIC-insured institution.

## Reserve Requirements

The Monetary Control Act of 1980 and the Federal Reserve’s Regulation D, “Reserve Requirements of Depository Institutions,” establish two categories of deposits for reserve-requirement purposes. The first category is the transaction account, which represents a deposit or account from which the depositor or account holder is permitted to make orders of withdrawals by negotiable instrument, payment orders of withdrawal, telephone transfer, or similar devices for making payments to a third party or others. Transaction accounts include demand deposits, NOW accounts, automatic transfer (ATS) accounts, and telephone or preauthorized transfer accounts. The second category is the non-transaction deposit account, which includes

all deposits that are not transaction accounts, such as (1) savings deposits, that is, money market deposit accounts and other savings deposits, and (2) time deposits, that is, time certificates of deposit and time deposits, open account. See Regulation D for specific definitions of the various deposit accounts.

## Treasury Tax and Loan Accounts

Member banks may select either the “remittance-option” or the “note-option” method to forward deposited funds to the U.S. Treasury. With the remittance option, the bank remits the Treasury Tax and Loan (TT&L) account deposits to the Federal Reserve Bank the next business day after deposit. The remittance portion is not interest-bearing.

The note option permits the bank to retain the TT&L deposits. With the note option, the bank debits the TT&L remittance account for the amount of the previous day’s deposit and simultaneously credits the note-option account. Thus, TT&L funds are now purchased funds evidenced by an interest-bearing, variable-rate, open-ended, secured note callable on demand by Treasury. Rates paid are  $\frac{1}{4}$  of 1 percent less than the average weekly rate on federal funds. Interest is calculated on the weekly average daily closing balance in the TT&L note-option account. Although there is no required maximum note-option ceiling, banks may establish a maximum balance by providing written notice to the Federal Reserve Bank. As per 31 CFR 203.24, the TT&L balance requires the bank to pledge collateral to secure these accounts, usually from its investment portfolio. The note option is not included in reserve-requirement computations and is not subject to deposit insurance because it is classified as a demand note issued to the U.S. Treasury, a type of borrowing.

## POTENTIAL PROBLEM AREAS

The following types of deposit accounts and related activities have above-average risk and, therefore, require the examiner’s special attention.

## Bank-Controlled Deposit Accounts

Bank-controlled deposit accounts, such as suspense, official checks, cash-collateral, dealer reserves, and undisbursed loan proceeds, are used to perform many necessary banking functions. However, the absence of sound administrative policies and adequate internal controls can cause significant loss to the bank. To ensure that such accounts are properly administered and controlled, the directorate must ensure that operating policies and procedures are in effect that establish acceptable purpose and use; appropriate entries; controls over posting entries; and the length of time an item may remain unrecorded, unposted, or outstanding. Internal controls that limit employee access to bank-controlled accounts, determine the responsibility for frequency of reconciliation, discourage improper posting of items, and provide for periodic internal supervisory review of account activity are essential to efficient deposit administration.

The deposit suspense account is used to process unidentified, unposted, or rejected items. Characteristically, items posted to such accounts clear in one business day. The length of time an item remains in control accounts often reflects on the bank's operational efficiency. This deposit type has a higher risk potential because the transactions are incomplete and require manual processing to be completed. As a result of the need for human interaction and the exception nature of these transactions, the possibility of misappropriation exists.

Official checks, a type of demand deposit, include bank checks, cashier's checks, expense checks, interest checks, dividend-payment checks, certified checks, money orders, and traveler's checks. Official checks reflect the bank's promise to pay a specified sum upon presentation of the bank's check. Because accounts are controlled and reconciled by bank personnel, it is important that appropriate internal controls are in place to ensure that account reconciliation is segregated from check origination. Operational inefficiencies, such as unrecorded checks that have been issued, can result in a significant understatement of the bank's liabilities. Misuse of official checks may result in substantial losses through theft.

Cash-collateral, dealer differential or reserve, undisbursed loan proceeds, and various loan escrow accounts are also sources of potential

loss. The risk lies in inefficiency or misuse if the accounts become overdrawn or if funds are diverted for other purposes, such as the payment of principal or interest on bank loans. Funds deposited to these accounts should be used only for their stated purposes.

## Brokered Deposits

As defined in Federal Deposit Insurance Corporation (FDIC) regulations, brokered deposits are funds a depository institution obtains, directly or indirectly, from or through the mediation or assistance of a deposit broker, for deposit into one or more deposit accounts (12 CFR 337.6). Thus, brokered deposits include both those in which the entire beneficial interest in a given bank deposit account or instrument is held by a single depositor and those in which the deposit broker pools funds from more than one investor for deposit in a given bank deposit account.

Section 29 of the Federal Deposit Insurance Act (the FDI Act) (12 USC 1831f(g)(1)) and the FDIC's regulations (12 CFR 337.6 (a)(5)) define *deposit broker* to mean—

- any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties; and
- an agent or a trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.

The term *deposit broker* does not include —

- an insured depository institution, with respect to funds placed with that depository institution;
- an employee of an insured depository institution, with respect to funds placed with the employing depository institution;
- a trust department of an insured depository institution, if the trust or other fiduciary relationship in question has not been established for the primary purpose of placing funds with insured depository institutions;
- the trustee of a pension or other employee benefit plan, with respect to funds of the plan;

- a person acting as a plan administrator or an investment adviser in connection with a pension plan or other employee benefit plan provided that person is performing managerial functions with respect to the plan;
- the trustee of a testamentary account;
- the trustee of an irrevocable trust,<sup>4</sup> as long as the trust in question has not been established for the primary purpose of placing funds with insured depository institutions;
- a trustee or custodian of a pension or profit-sharing plan qualified under section 401(d) or 403(a) of the Internal Revenue Code of 1986 (26 USC 401(d), 503(a)); or
- an agent or a nominee whose primary purpose is not the placement of funds with depository institutions; or
- an insured depository institution acting as an intermediary or agent of a U.S. government department or agency for a government-sponsored minority or women-owned depository institution deposit program.

A small- or medium-sized bank's dependence on the deposits of customers who reside or conduct their business outside of the bank's normal service area should be closely monitored by the bank and analyzed by the examiner. Such deposits may be the product of personal relationships or good customer service; however, large out-of-area deposits are sometimes attracted by liberal credit accommodations or significantly higher interest rates than competitors offer. Deposit growth that is due to liberal credit accommodations generally proves costly in terms of the credit risks taken relative to the benefits received from corresponding deposits, which may be less stable. Banks outside dynamic metropolitan areas are limited in growth because they usually can maintain stable deposit growth only as a result of prudent reinvestment in the bank's service area. Deposit development and retention policies should recognize the limits imposed by prudent competition and the bank's service area.

Historically, most banking organizations have not relied on funds obtained through deposit brokers to supplement their traditional funding sources. A concern regarding the activities of deposit brokers is that the ready availability of

large amounts of funds through the issuance of insured obligations undercuts market discipline.

The use of brokered deposits by sound, well-managed banks can play a legitimate role in the asset-liability management of a bank and enhance the efficiency of financial markets. However, the use of brokered deposits also can contribute to the weakening of a bank by allowing it to grow at an unmanageable or imprudent pace and can exacerbate the condition of a troubled bank. Consequently, without proper monitoring and management, brokered and other highly rate-sensitive deposits, such as those obtained through the Internet, certificate of deposit (CD) listing services, and similar advertising programs, may be unstable sources of funding for an institution.

Deposits attracted over the Internet, through CD listing services, or through special advertising programs offering premium rates to customers without another banking relationship, require special monitoring. Although these deposits may not fall within the technical definition of "brokered" in 12 USC 1831f and 12 CFR 337.6, their inherent risk characteristics are similar to brokered deposits. That is, such deposits are typically attractive to rate-sensitive customers who may not have significant loyalty to the bank. Extensive reliance on funding products of this type, especially those obtained from outside a bank's geographic market area, has the potential to weaken a bank's funding position.

Some banks have used brokered and Internet-based funding to support rapid growth in loans and other assets. In accordance with the safety-and-soundness standards, a bank's asset growth should be prudent and its management must consider the source, volatility, and use of the funds generated to support asset growth. (See 12 CFR 208 appendix D-1.)

To compensate for the high rates typically offered for brokered deposits, institutions holding them tend to seek assets that carry commensurately high yields. These assets can often involve excessive credit risk or cause the bank to take on undue interest-rate risk through a mismatch in the maturity of assets and liabilities. The FDI Act (12 USC 1831f) includes certain restrictions on the use of brokered deposits to prohibit undercapitalized insured depository institutions from accepting funds obtained, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts.

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4. This exception does not apply to an agent or a trustee who establishes a deposit account to facilitate a business arrangement with an insured depository institution to use the proceeds of the account to fund a prearranged loan.



### Capital Categories

For the purposes of section 29 of the FDI Act, the regulations of the FDIC and the Federal Reserve (for the FDIC, 12 CFR 325.103 and for the Federal Reserve, 12 CFR 208.43) provide the definitions of well-capitalized, adequately capitalized, and undercapitalized financial institutions (banks). These definitions are tied to percentages of leverage and risk-based capital. Section 29 of the FDI Act limits the rates of interest on brokered deposits that may be offered by insured depository institutions that are adequately capitalized or undercapitalized.

*Well-capitalized bank.* A bank is deemed to be *well capitalized* if it—

- has a total risk-based capital ratio of 10.0 percent or greater;
- has a tier 1 risk-based capital ratio of 6.0 percent or greater;
- has a leverage ratio of 5.0 percent or greater; and
- is not subject to any written agreement, order, capital directive, or prompt-corrective-action directive issued by the Board pursuant to section 8 of the FDI Act (12 USC 1818), the International Lending Supervision Act of 1983 (12 USC 3907), or section 38 of the FDI Act (12 USC 1831o), or any regulation thereunder, to meet and maintain a specific capital level for any capital measure.

A well-capitalized insured depository institution may solicit and accept, renew, or roll over any brokered deposit without restriction.

*Adequately capitalized bank.* A bank is deemed to be *adequately capitalized* if it—

- has a total risk-based capital ratio of 8.0 percent or greater;
- has a tier 1 risk-based capital ratio of 4.0 percent or greater;
- has—
  - a leverage ratio of 4.0 percent or greater or
  - a leverage ratio of 3.0 percent or greater if the bank is rated composite 1 under the CAMELS rating system in the most recent examination of the bank and is not experiencing or anticipating significant growth; and

- does not meet the definition of a well capitalized bank.

An adequately capitalized insured depository institution may not accept, renew, or roll over any brokered deposit unless it has applied for and been granted a waiver of this prohibition by the FDIC. If the insured depository institution has been granted a waiver by the FDIC, the institution may accept, renew, or roll over a brokered deposit. The institution may not pay an effective yield on the deposit that exceeds, by more than 75 basis points: (1) the effective yield paid on deposits of comparable size and maturity, and for deposits accepted, within the institution's normal market area<sup>5</sup> or (2) the "national rate" paid on deposits of comparable size and maturity for deposits accepted outside the institution's normal market area. The national rate is either 120 or 130 basis points of the current yield on similar-maturity U.S. Treasury obligations, depending on whether the deposit is FDIC insured or more than half uninsured (the portion of the deposit that is in excess of the FDIC-insured limit, as detailed in the rule).

If an FDIC-insured bank is adequately capitalized and does not have a waiver from the FDIC, it may not use a broker to obtain deposits. The following rate restrictions on deposits also apply: (1) the deposit rates may be no more than 75 basis points over the effective yield on deposits of comparable size and maturity within the bank's normal market area and (2) the deposit rates may not be based on a "national" rate.

*Undercapitalized bank.* A bank is deemed to be *undercapitalized* if it—

- has a total risk-based capital ratio that is less than 8.0 percent;
- has a tier 1 risk-based capital ratio that is less than 4.0 percent;
- has a leverage ratio that is less than 4.0 percent;<sup>6</sup> or
- has a leverage ratio that is less than 3.0 per-

5. For deposits obtained through Internet solicitations, the determination of the bank's "normal market area" is particularly problematic and difficult.

6. An exception is available when (1) the bank (the insured depository institution) has a leverage ratio of 3.0 percent or greater, (2) the bank is rated composite 1 under the CAMELS rating system following its most-recent bank examination, and (3) the bank is not experiencing or anticipating significant growth.

cent, if the bank is rated composite 1 under the CAMELS rating system in the most recent examination of the bank and is not experiencing or anticipating significant growth.

An undercapitalized insured depository institution may not accept, renew, or roll over any brokered deposit. Also, an undercapitalized insured depository institution (and any employee of the institution) may not solicit deposits by offering an effective yield that exceeds by more than 75 basis points the prevailing effective yields on insured deposits of comparable maturity in the institution's normal market area or in the market area in which such deposits are being solicited.

Each examination should include a review for compliance with the FDIC's limitations on the acceptance of brokered deposits and guidelines on interest payments. The use of brokered deposits should be reviewed during all on-site examinations, even in those institutions not subject to the FDIC's restrictions. Given the potential risks involved in using brokered deposits, the examination should focus on the—

- rate of growth and the credit quality of the loans or investments funded by brokered deposits;
- corresponding quality of loan files, documentation, and customer credit information;
- ability of bank management to adequately evaluate and administer these credits and manage the resulting growth;
- degree of interest-rate risk involved in the funding activities and the existence of a possible mismatch in the maturity or rate sensitivity of assets and liabilities;
- composition and stability of the deposit sources and the role of brokered deposits in the bank's overall funding position and strategy; and
- effect of brokered deposits on the bank's financial condition and whether the use of brokered deposits constitutes an unsafe and unsound banking practice.

The examiner should identify relevant concerns in the examination report when brokered deposits amount to 5 percent or more of the bank's total deposits.

### *Risk-Management Expectations for Brokered Deposits*

On May 11, 2001, the Federal Reserve Board and the other federal banking agencies (the agencies) issued a Joint Agency Advisory on Brokered and Rate-Sensitive Deposits. The advisory sets forth the following risk-management guidelines for brokered deposits. The bank's management is expected to implement risk-management systems that are commensurate in complexity with the liquidity and funding risks that the bank undertakes. (See SR-01-14.) Such systems should incorporate the following principles:

- *Proper funds-management policies.* A good policy should generally provide for forward planning, establish an appropriate cost structure, and set realistic limitations and business strategies. It should clearly convey the board's risk tolerance and should not be ambiguous about who holds responsibility for funds-management decisions.
- *Adequate due diligence when assessing deposit brokers.* Bank management should implement adequate due diligence procedures before entering any business relationship with a deposit broker. The agencies do not regulate deposit brokers.
- *Due diligence in assessing the potential risk to earnings and capital associated with brokered or other rate-sensitive deposits, and prudent strategies for their use.* Bankers should manage highly sensitive funding sources carefully, avoiding excessive reliance on funds that may be only temporarily available or which may require premium rates to retain.
- *Reasonable control structures to limit funding concentrations.* Limit structures should consider typical behavioral patterns for depositors or investors and be designed to control excessive reliance on any significant source(s) or type of funding. This includes brokered funds and other rate-sensitive or credit-sensitive deposits obtained through the Internet or other types of advertising.
- *Management information systems (MIS) that clearly identify nonrelationship or higher-cost funding programs and allow management to track performance, manage funding gaps, and monitor compliance with concentration and*

*other risk limits.* At a minimum, MIS should include a listing of funds obtained through each significant program, rates paid on each instrument and an average per program, information on maturity of the instruments, and concentration or other limit monitoring and reporting. Management also should ensure that brokered deposits are properly reported in the bank's Consolidated Reports of Condition and Income.<sup>7</sup>

- *Contingency funding plans that address the risk that these deposits may not “roll over” and provide a reasonable alternative funding strategy.* Contingency funding plans should factor in the potential for changes in market acceptance if reduced rates are offered on rate-sensitive deposits. The potential for triggering legal limitations that restrict the bank's access to brokered deposits under Prompt Corrective Action (PCA) standards, and the effect that this would have on the bank's liability structure, should also be factored into the plan.

Examiners should assess carefully the liquidity-risk management framework at all banks. Banks with meaningful reliance on brokered or other rate-sensitive deposits should receive the appropriate level of supervisory attention. Examiners should not wait for PCA provisions to be triggered or the viability of the bank to come into question, before raising relevant safety-and-soundness issues with regard to the use of these funding sources. If a determination is made that a bank's use of these funding sources is not safe and sound, or that these risks are excessive or that they adversely affect the bank's condition, then the examiner or central point of contact should recommend to the Reserve Bank management that it consider taking immediate appropriate supervisory action. The following represent potential red flags that may indicate the need to take such action to ensure the risks associated with brokered or other rate-sensitive funding sources are managed appropriately:

- ineffective management or the absence of appropriate expertise
- a newly chartered institution with few rela-

tionship deposits and an aggressive growth strategy

- inadequate internal audit coverage
- inadequate information systems or controls
- identified or suspected fraud
- high on- or off-balance-sheet growth rates
- use of rate-sensitive funds not in keeping with the bank's strategy
- inadequate consideration of risk, with management focus exclusively on rates
- significant funding shifts from traditional funding sources
- the absence of adequate policy limitations on these kinds of funding sources
- high loan delinquency rate or deterioration in other asset-quality indicators
- deterioration in the general financial condition of the institution
- other conditions or circumstances warranting the need for administrative action

## Check Kiting

Check kiting occurs when—

- a depositor with accounts at two or more banks draws checks against the uncollected balance at one bank to take advantage of the float—that is, the time required for the bank of deposit to collect from the paying bank, and
- the depositor initiates the transaction with the knowledge that sufficient collected funds will not be available to support the amount of the checks drawn on all of the accounts.

The key to this deceptive practice, the most prevalent type of check fraud, is the ability to draw against uncollected funds. However, drawing against uncollected funds in and of itself does not necessarily indicate kiting. Kiting only occurs when the aggregate amount of drawings exceeds the sum of the collected balances in all accounts. Nevertheless, since drawing against uncollected funds is the initial step in the kiting process, management should closely monitor this activity. The requirements of Regulation CC, Availability of Funds and Collection of Checks, increased the risk of check kiting, and should be addressed in a bank's policies and procedures.

By allowing a borrower to draw against uncollected funds, the bank is extending credit that should be subject to an appropriate approval

7. See the FFIEC bank Call Report and Instructions for Consolidated Reports of Condition and Income, Schedule RC-E—Deposit Liabilities.

process. Accordingly, management should promptly investigate unusual or unauthorized activity since the last bank to recognize check kiting and pay on the uncollected funds suffers the loss. Check kiting is illegal and all suspected or known check kiting operations should be reported pursuant to established Federal Reserve policy. Banks should maintain internal controls to preclude loss from kiting, and the examiner should remember that in most cases kiting is not covered under Blanket Bond Standard Form 24.

## Delayed Disbursement Practices

Although Regulation CC, Availability of Funds and Collection of Checks, stipulates time frames for funds availability and return of items, delayed disbursement practices (also known as remote disbursement practices) can present certain risks, especially concerning cashier's checks, which have next-day availability. Delayed disbursement is a common cash management practice that consists of arrangements designed to delay the collection and final settlement of checks by drawing checks on institutions located substantial distances from the payee or on institutions located outside the Federal Reserve cities when alternate and more efficient payment arrangements are available. Such practices deny depositors the availability of funds to the extent that funds could otherwise have been available earlier. A check drawn on an institution remote from the payee often results in increased possibilities of check fraud and in higher processing and transportation costs for return items.

Delayed disbursement arrangements could give rise to supervisory concerns because a bank may unknowingly incur significant credit risk through such arrangements. The remote location of institutions offering delayed disbursement arrangements often increases the collection time for checks by at least a day. The primary risk is payment against uncollected funds, which could be a method of extending unsecured credit to a depositor. Absent proper and complete documentation regarding the creditworthiness of the depositor, paying items against uncollected funds could be considered an unsafe or unsound banking practice. Furthermore, such loans, even if properly documented, might exceed the bank's legal lending limit for loans to one customer.

Examiners should routinely review a bank's practices in this area to ensure that such prac-

tices are conducted prudently. If undue or undocumented credit risk is disclosed or if lending limits are exceeded, appropriate corrective action should be taken.

## Deposit Sweep Programs or Master-Note Arrangements

Deposit sweep programs or master-note arrangements (sweep programs) can be implemented on a bank level or on a parent bank holding company (BHC) level. On a bank level, these sweep programs exist primarily to facilitate the cash-management needs of bank customers, thereby retaining customers who might otherwise move their account to an entity offering higher yields. On a BHC level, the sweep programs are maintained with customers at the bank level, and the funds are upstreamed to the parent as part of the BHC's funding strategy. Sweep programs use an agreement with the bank's deposit customers (typically corporate accounts) that permits these customers to reinvest amounts in their deposit accounts above a designated level in overnight obligations of the parent bank holding company, another affiliate of the bank, or a third party. These obligations include instruments such as commercial paper, program notes, and master-note agreements. (See SR-90-31.)

The disclosure agreement regarding the sale of the nondeposit debt obligations should include a statement indicating that these instruments are not federally insured deposits or obligations of or guaranteed by an insured depository institution. In addition, banks and their subsidiaries that have issued or plan to issue nondeposit debt obligations should not market or sell these instruments in any public area of the bank where retail deposits are accepted, including any lobby area of the bank. This requirement exists to convey the impression or understanding that the purchase of such obligations by retail depositors of the subsidiary bank can, in the event of default, result in losses to individuals who believed they had acquired federally insured or guaranteed obligations.

### *Bank Policies and Procedures*

Banking organizations with sweep programs should have adequate policies, procedures, and internal controls in place to ensure that the

activity is conducted in a manner consistent with safe and sound banking principles and in accordance with all banking laws and regulations. Bank policies and procedures should further ensure that deposit customers participating in a sweep program are given proper disclosures and information. When a sweep program is used as part of a funding strategy for a BHC or a nonbank affiliate, examiners should ensure that liquidity and funding strategies are carried out in a prudent manner.

### *Application of Deposit Proceeds*

In view of the extremely short-term maturity of most swept funds, banks and BHCs are expected to exercise great care when investing the proceeds. Banks, from whom deposit funds are swept, have a fiduciary responsibility to their customers to ensure that such transactions are conducted properly. Appropriate uses of the proceeds of deposit sweep funds are limited to short-term bank obligations, short-term U.S. government securities, or other highly liquid, readily marketable, investment-grade assets that can be disposed of with minimal loss of principal.<sup>8</sup> When deposit sweep funds are invested in U.S. government securities, appropriate agreements must be in place, required disclosures must be made, and daily confirmations must be provided to the customer in accordance with the requirements of the Government Securities Act of 1986. Use of such proceeds to finance mismatched asset positions, such as those involving leases, loans, or loan participations, can lead to liquidity problems and are not considered appropriate. The absence of a clear ability to redeem overnight or extremely short-term liabilities when they become due should generally be viewed as an unsafe and unsound banking activity.

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8. Some banking organizations have interpreted language in a 1987 letter signed by the secretary of the Board as condoning funding practices that may not be consistent with the principles set forth in a subsequent supervisory letter dated September 21, 1990, as well as with prior Board rulings. The 1987 letter involved a limited set of facts and circumstances that pertained to a particular banking organization; it did not establish or revise Federal Reserve policies on the proper use of the proceeds of short-term funding sources. In any event, banking organizations should no longer rely on the 1987 letter to justify the manner in which they use the proceeds of sweep programs. Banking organizations employing sweep programs are expected to ensure that these programs conform with the policies in this manual section.

### *Funding Strategies*

A key principle underlying the Federal Reserve's supervision of banking organizations is that BHCs operate in a way that promotes the soundness of their subsidiary banks. BHCs are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their banks. Any funding strategy should maintain an adequate degree of liquidity at both the parent level and the subsidiary bank level. Bank management should avoid, to the extent possible, allowing sweep programs to serve as a source of funds for inappropriate uses at the BHC or at an affiliate. Concerns exist in this regard because funding mismatches can exacerbate an otherwise manageable period of financial stress and, in the extreme, undermine public confidence in a banking organization's viability.

### *Funding Programs*

In developing and carrying out funding programs, BHCs should give special attention to the use of overnight or extremely short-term liabilities, since a loss of confidence in the issuing organization could lead to an immediate funding problem. Thus BHCs relying on overnight or extremely short-term funding sources should maintain a sufficient level of superior-quality assets (at a level at least equal to the amount of the funding sources') that can be immediately liquidated or converted to cash with minimal loss.

### *Dormant Accounts*

A dormant account is one in which customer-originated activity has not occurred for a predetermined period of time. Because of this inactivity, dormant accounts are frequently the target of malfeasance and should be carefully controlled by a bank. Bank management should establish standards that specifically outline the bank's policy for the effective control of dormant accounts, addressing—

- the types of deposit categories that could contain dormant accounts, including demand, savings, and official checks;
- the length of time without customer-originated activity that qualifies an account to be identified as dormant;



- the controls exercised over the accounts and their signature cards, that is, prohibiting release of funds by a single bank employee; and
- the follow-up by the bank when ordinary bank mailings, such as account statements and advertising flyers, are returned to the bank because of changed addresses or other reasons for failure to deliver.

## Employee Deposit Accounts

Historically, examiners have discovered various irregularities and potential malfeasance through review of employee deposit accounts. As a result, bank policy should establish standards that segregate or specially encode employee accounts and should encourage periodic internal supervisory review. In light of these concerns, examiners should review related bank procedures and practices, taking appropriate measures when warranted.

## Overdrafts

The size, frequency, and duration of deposit-account overdrafts are matters that should be governed by bank policy and controlled by adequate internal controls, practices, and procedures. Overdraft authority should be approved in the same manner as lending authority and should never exceed the employee's lending authority. Systems for monitoring and reporting overdrafts should emphasize a secondary level of administrative control that is distinct from other lending functions so account officers who are less than objective do not allow influential customers to exploit their overdraft privileges. A bank's payment of overdrafts of executive officers and directors of the bank is generally prohibited under Regulation O. (See 12 CFR 215.4(e).) It is the board of directors' responsibility to review overdrafts as they would any other extension of credit. Overdrafts outstanding for more than 60 days, lacking mitigating circumstances, should be considered for charge-off. See SR-05-3/CA-05-2 and section 2130.1 on the February 18, 2005, Interagency Joint Guidance on Overdraft Protection Programs.

## Payable-Through Accounts

A payable-through account is an accommodation offered to a correspondent bank or other customer by a U.S. banking organization whereby drafts drawn against client subaccounts at the correspondent are paid upon presentation by the U.S. banking institution. The subaccount holders of the payable-through bank are generally non-U.S. residents or owners of businesses located outside of the United States. Usually the contract between the U.S. banking organization and the payable-through bank purports to create a contractual relationship solely between the two parties to the contract. Under the contract, the payable-through bank is responsible for screening subaccount holders and maintaining adequate records with respect to such holders. The examiner should be aware of the potential effect of money laundering.

## Public Funds

Public funds generally represent deposits of the U.S. government, as well as state and political subdivisions, and typically require collateral in the form of securities to be pledged against them. A bank's reliance upon public funds can cause potential liquidity concerns if the aggregate amount, as a percentage of total deposits, is material relative to the bank's asset-liability management practices. Another factor that can cause potential liquidity concerns relates to the volatile nature of these deposits.

This volatility occurs because the volume of public funds normally fluctuates on a seasonal basis due to timing differences between tax collections and expenditures. A bank's ability to attract public funds is typically based upon the government entity's assessment of three key points:

- the safety and soundness of the institution with which the funds have been placed
- the yield on the funds being deposited
- that such deposits are placed with a bank that can provide or arrange the best banking service at the least cost

Additionally, banks that offer competitive interest rates and provide collection, financial advisory, underwriting, and data processing services at competitive costs are frequently chosen as depositories. Public funds deposits acquired

through political influence should be regarded as particularly volatile. As a result, an examiner should pay particular attention to assessing the volatility of such funds in conjunction with the review of liquidity.

### Zero-Balance Accounts

Zero-balance accounts (ZBAs) are demand deposit accounts used by a bank's corporate customers through which checks or drafts are received for either deposit or payment. The total amount received on any particular day is offset by a corresponding debit or credit to the account before the close of business to maintain the balance at or near zero. ZBAs enable a corporate treasurer to effectively monitor cash receipts and disbursements. For example, as checks arrive for payment, they are charged to a ZBA with the understanding that funds to cover the checks will be deposited before the end of the banking day. Several common methods used to cover checks include—

- wire transfers;
- depository transfer checks, a bank-prepared payment instrument used to transfer money from a corporate account in one bank to another bank;
- concentration accounts, a separate corporate

demand deposit account at the same bank used to cover deficits or channel surplus funds relative to the ZBA; or

- extended settlement, a cash-management arrangement that does not require the corporate customer to provide same-day funds for payment of its checks.

Because checks are covered before the close of business on the day they arrive, the bank's exposure is not reflected in the financial statement. The bank, however, assumes risk by paying against uncollected funds, thereby creating unsecured extensions of credit during the day (which is referred to as a daylight overdraft between the account holder and the bank). If these checks are not covered, an overdraft occurs, which will be reflected on the bank's financial statement.

The absence of prudent safeguards and a lack of full knowledge of the creditworthiness of the depositor may expose the bank to large, unwarranted, and unnecessary risks. Moreover, the magnitude of unsecured credit risk may exceed prudent limits. Examiners should routinely review cash-management policies and procedures to ensure that banks do not engage in unsafe and unsound banking practices, making appropriate comments in the report of examination, as necessary.

# Deposit Accounts

## Examination Objectives

Effective date November 2006

## Section 3000.2

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1. To determine if the policies, practices, procedures, and internal controls regarding deposit accounts are adequate.
2. To determine if the bank's management implemented adequate risk-management systems for brokered and rate-sensitive deposits that are commensurate with the liquidity and funding risks the bank has undertaken.
3. To determine if the bank's policies, practices, procedures, and internal controls (including compliance oversight, management reporting, and staff training) for account relationships involving foreign governments, foreign embassies, and foreign political figures (as well as foreign-currency customer deposit accounts) are adequate for the varied risks posed by these accounts.
4. To determine if bank officers and employees are operating in conformance with the bank's established guidelines.
5. To evaluate the deposit structure and determine its characteristics and volatility.
6. To determine the scope and adequacy of the audit function.
7. To determine compliance with applicable laws and regulations.
8. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations are noted.



# Deposit Accounts

## Examination Procedures

Effective date April 2012

## Section 3000.3

1. Determine the scope of the examination of the deposit-taking function. In so doing, consider the findings of prior examinations, related work prepared by internal and external auditors, deficiencies in internal controls noted within other bank functions, and the requirements of examiners assigned to review the asset/liability management and interest-rate risk aspects of the bank.
2. If required by the scope, implement the "Deposit Accounts" internal control questionnaire.
3. Test the deposit function for compliance with policies, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest internal or external audit review, then determine if appropriate corrections have been made.
4. In conducting the examination, use available bank copies of printouts plus transactions journals or other visual media to minimize expense to the bank. However, if copies of these reports are not available, determine what information is necessary to complete the examination procedures and request that information from the bank.

Obtain or prepare, as applicable, the reports indicated below, which are used for a variety of purposes, including the assessment of deposit volatility and liquidity, the assessment of the adequacy of internal controls, the verification of information on required regulatory reports, and the assessment of loss.

  - a. For demand deposits and other transaction accounts:
    - trial balance
    - overdrafts
    - unposted items
    - nonsufficient-funds (NSF) report
    - dormant accounts
    - public funds
    - uncollected funds
    - due to banks
    - trust department funds
    - significant activity
    - suspected kiting report
    - matured certificates of deposit without an automatic renewal feature
    - large-balance report
  - b. For official checks:
    - trial balance(s)
    - exception list
  - c. For savings accounts:
    - trial balance
    - unposted items
    - overdrafts
    - dormant accounts
    - public funds
    - trust department funds
    - large-balance report
  - d. For other time deposits:
    - trial balance(s)
    - large-balance report
    - unposted items
    - public funds
    - trust department funds
    - money market accounts
  - e. For certificates of deposit:
    - trial balance(s)
    - unposted items
    - public funds
    - certificates of \$100,000 or more
    - negotiable certificates of deposit
    - maturity reports
    - matured certificates of deposit
  - f. For deposit sweep programs or master-note arrangements, list individually by deposit type and amount.
  - g. For brokered deposits, list individually by deposit type, including amount and rate.
  - h. For bank-controlled accounts:
    - reconciliation records for all such accounts
    - names and extensions of individuals authorized to make entries to such accounts
    - name and phone extension of reconciliation clerk(s)
  - i. For the bank's foreign-currency customer deposit accounts and the deposit accounts for foreign governments, embassies, and political figures:
    - list of accounts and currency type
    - list of currency transactions over \$10,000 for each account, and the copies of their Currency Transaction

- Report or its equivalent, since the previous examination (See 31 CFR 1010.330 and its examples.)
- the most recent internal audit report covering the review of those accounts, the risks associated with the accounts, the internal controls over those accounts, and the staff's completion of the Currency Transaction Report
  - the completed copies of the Report of Foreign (Non-U.S.) Currency Deposits, Form 2915, that have been submitted since the previous examination
5. Review the reconciliation of all types of deposit accounts. Verify the balances to department controls and the general ledger.
    - a. Determine if reconciliation items are legitimate and if they clear within a reasonable time frame.
    - b. Retain custody of all trial balances until items outstanding are resolved.
  6. Review the reconciliation process for bank-controlled accounts, such as official checks and escrow deposits, by—
    - a. determining if reconciling items are legitimate and if they clear within a reasonable time frame;
    - b. scanning activity in such accounts to determine the potential for improper diversion of funds for various uses, such as—
      - political contributions,
      - loan payments (principal and interest), or
      - personal use; and
    - c. determining if checks are being processed before their related credits.
  7. Review the bank's operating procedures and reconciliation process relative to suspense accounts. Determine if—
    - a. the disposition process of unidentified items is completed in a timely fashion;
    - b. reports are generated periodically to inform management of the type, age, and amount of items in such accounts; and
    - c. employees responsible for clearing suspense-account items are not shifting the items between accounts.
  8. Evaluate the effectiveness of the written policies and procedures and of management's reporting methods regarding overdrafts and drawings against uncollected funds.
    - a. Concerning overdrafts, determine if—
      - officer-approval limits have been established, and
      - a formal system of review and approval is in effect.
    - b. Determine whether the depository institution has an overdraft-protection program and if it has adequate written policies and procedures to address the credit, operational, and other risks associated with those programs. See the February 18, 2005, interagency Joint Guidance on Overdraft Protection Programs (SR-05-3/CA-05-2). If the bank provides overdraft protection, perform the following procedures:
      - Obtain a master list of all depositors with formal overdraft protection.
      - Obtain a trial balance indicating advances outstanding and compare it with the master list to ensure compliance with approved limits.
      - Cross-reference the trial balance or master list to examiner loan line sheets.
      - Review credit files on significant formal agreements not cross-referenced above.
      - Ascertain whether there is ongoing monitoring of overdrafts to identify customers who may pose an undue credit risk to the bank.
      - Find out if the bank has incorporated into its overdraft-protection program prudent risk-management practices pertaining to account repayment and the suspension of a customer's overdraft-protection services when the customer does not satisfy repayment and eligibility requirements.
      - Determine whether overdrafts are properly and accurately reported according to generally accepted accounting principles on the bank's financial statements and on its Reports of Condition and Income (Call Reports). Verify that overdrafts are reported as loans on the Report of Condition.
      - Verify the existence of the bank's loss-estimation procedures for overdraft and fee balances. Determine if the procedures are adequately rigorous and if losses are properly accounted for as part of (1) the allowance for loan and lease losses (ALLL) or (2) the loss allowance for uncollectible fees (alternatively, the bank may recognize only

- that portion of earned fees estimated to be collectible), if applicable.<sup>1</sup>
- When applicable, validate (1) whether the bank's overdraft commitments have been assigned the correct conversion factor, (2) whether they are accurately risk-weighted by obligor, and (3) if the commitment terms comply with the risk-based capital guidelines.
  - Determine whether the bank has obtained assurances from its legal counsel that its overdraft-protection program is fully compliant with all applicable federal and state laws and regulations, including the Federal Trade Commission Act.
  - When the bank contracts with third-party vendors to do information technology work, determine if the bank conducted proper due diligence before entering into the contract and that it followed the November 28, 2000, guidance on the Risk Management of Outsourced Technology Services. (See SR-00-17.)
- c. Concerning drawings against uncollected funds, determine if—
- the uncollected-funds report reflects balances as uncollected until they are actually received;
  - management is comparing reports of significant changes in balances and activity volume with uncollected-funds reports;
  - management knows the reasons why a depositor is frequently drawing against uncollected funds;
  - a reporting system to inform senior management of significant activity in the uncollected-funds area has been instituted; and
  - appropriate employees clearly understand the mechanics of drawing against uncollected funds and the risks involved, especially in the area of potential check-kiting operations.
- d. After completing steps 8.a., 8.b., and 8.c.—
- cross-reference overdraft and uncollected-funds reports to examiner loan line sheets;
  - review the credit files of depositors with significant overdrafts, if available, or the credit files of depositors who frequently draw significant amounts against uncollected funds, for those depositors not cross-referenced in the preceding step;
  - request management to charge off overdrafts deemed to be uncollectible; and
  - submit a list of the following items to the appropriate examiner:
    - overdrafts considered loss, indicating borrower and amount
    - aggregate amounts overdrawn 30 days or more past due, for inclusion in past-due statistics
9. Review the bank's deposit development and retention policy, which is often included in the funds-management policy.
- a. Determine if the policy addresses the deposit structure and related interest costs, including the percentages of time deposits and demand deposits of—
    - individuals,
    - corporations, and
    - public entities.
  - b. Determine if the policy requires periodic reports to management comparing the accuracy of projections with results.
  - c. Assess the reasonableness of the policy, and ensure that it is routinely reviewed by management.
10. If a deposit sweep program or master-note arrangement exists, review the minutes of the board of directors for approval of related policies and procedures.
11. For banks with deposit sweep programs or master-note arrangements (sweep programs), compare practices for adherence to approved policies and procedures. Review the following:
- a. The purpose of the sweep program: Is it strictly a customer-accommodation transaction, or is it intended to fund certain assets at the holding company level or at an affiliate? Review funding transactions in light of liquidity and funding needs of the banking organization by referring to section 4020.1.
  - b. The eligibility requirements used by the bank to determine the types of customers and accounts that may participate in a sweep program, including—
    - a list of customers participating in

1. Institutions may charge off uncollectible overdraft fees against the ALLL if such fees are recorded with overdraft balances as loans and if estimated credit losses on the fees are provided for in the ALLL.

- sweep programs, with dollar amounts of deposit funds swept on the date of examination, and
- the name of the recipient(s) of swept funds.
    - If the recipient is an affiliate of the bank, include a schedule of the instruments into which the funds were swept, including the effective maturity of these instruments.
    - If the recipient is an unaffiliated third party, determine if the bank adequately evaluates the third party's financial condition at least annually. Also, verify if a fee is received by the bank for the transaction. If so, determine that the fee is disclosed in customer documentation.
- c. Whether the proceeds of sweep programs are invested only in short-term bank obligations; short-term U.S. government securities; or other highly liquid, readily marketable, investment-grade assets that can be disposed of with minimal loss of principal.
- d. Whether the bank and its subsidiaries have issued or plan to issue nondeposit debt obligations in any public area of the bank where retail deposits are accepted, including any lobby area of the bank.
- e. Completed sweep-program documents to determine the following:
- Signed documents boldly disclose that the instrument into which deposit funds will be swept is not insured by the FDIC and is not an obligation of, or guaranteed by, the bank.
  - Proper authorization for the instrument exists between the customer and an authorized representative of the bank.
  - Signed documents properly disclose the name of the obligor and the type of instrument into which the depositor's funds will be swept. If funds are being swept into U.S. government securities held by the banking organization, verify that adequate confirmations are provided to customers in accordance with the Government Securities Act of 1986. (This act requires that all transactions subject to a repurchase agreement be confirmed in writing at the end of the day of initiation and that the confirmation confirms specific securities. If any other securities are substituted that result in a change of issuer, maturity date, par amount, or coupon rate, another confirmation must be issued at the end of the day during which the substitution occurred. Because the confirmation or safekeeping receipt must list specific securities, "pooling" of securities for any type of sweep program involving government securities is not permitted. Additionally, if funds are swept into other instruments, similar confirmation procedures should be applied.)
- f. Conditions of the sweep program are stated clearly, including the dollar amount (minimum or maximum amounts and incremental amounts), time frame of sweep, time of day the sweep transaction occurs, fees payable, transaction confirmation notice, prepayment terms, and termination notice.
- g. The length of any single transaction under sweep programs in effect has not exceeded 270 days and the amount is \$25,000 or more (as stipulated by SEC policy). Ongoing sweep-program disclosures should occasionally be sent to the customer to ensure that the terms of the program are updated and the customer understands the terms.
- f. Samples of advertisements (newspaper, radio, television spots, etc.) by the bank for sweep programs to determine if the advertisements—
- boldly disclose that the instrument into which deposit funds are swept is not insured by the FDIC and is not an obligation of, or guaranteed by, the bank, and
  - are not enclosed with insured deposit statements mailed to customers.
- g. Whether the sweep program has had a negative effect on bank liquidity or has the potential to undermine public confidence in the bank.
- Review the bank's federal funds and borrowing activities to ascertain whether borrowings appear high. If so, compare the bank's borrowing activity with daily balances of aggregate sweep transactions on selected dates to see if a correlation exists.

- If sweep activity is significant, compare the rates being paid on swept deposits with the yields received on the invested funds and with the rates on other overnight funding instruments, such as federal funds, to determine if they are reasonable.
12. Forward the following to the examiner assigned to asset/liability management:
    - a. the amount of any deposit decline or deposit increase anticipated by management (the time period will be determined by the examiner performing asset/liability management)
    - b. a listing by name and amount of any depositor controlling more than 1 percent of total deposits
    - c. a listing, if available, by name and amount of any deposits held solely because of premium rates paid (brokered deposits)
    - d. the aggregate amount of brokered deposits
    - e. a maturity schedule of certificates of deposit, detailing maturities within the next 30, 60, 90, 180, and 360 days
    - f. an assessment of the overall characteristics and volatility of the deposit structure
  13. Analyze UBPR data on deposits and related expense ratios, and compare with peer-group norms to determine—
    - a. variations from the norm, and
    - b. trends in the deposit structure with respect to—
      - growth patterns, and
      - shifts between deposit categories.
  14. Assess the volatility and the composition of the bank's deposit structure.
    - a. Review the list of time certificates of deposit of \$100,000 or more and related management reports, including those on brokered deposits, to determine—
      - whether concentrations of maturing deposits exist;
      - whether a concentration of deposits to a single entity exists;
      - the aggregate dollar volume of accounts of depositors outside the bank's normal service area, if significant, and the geographic areas from which any significant volume emanates;
      - the aggregate dollar volume of CDs that have interest rates higher than current publicly quoted rates within the market;
    - b. whether the bank is paying current market rates on CDs;
    - the dollar amount of brokered CDs, if any; and
    - the dollar volume of deposits obtained as a result of special promotions.
- b. *Federal Deposit Insurance Corporation Improvement Act of 1991* (12 USC 1831F).
    - If the bank is undercapitalized, as defined in the FDIC's regulation on brokered deposits, ensure that it is not accepting brokered deposits. (See 12 CFR 337.6.)
    - If the bank is only adequately capitalized, as defined in the FDIC's regulation and is accepting brokered deposits, ensure that a waiver authorizing acceptance of such deposits has been obtained from the FDIC and that the bank is in compliance with the interest-rate restrictions. (See 12 CFR 337.6(b)(2) and (3).)
  - c. Determine if the bank has risk-management systems to monitor and control its liquidity and funding risks that are associated with the bank's brokered and rate-sensitive deposits.
  - d. Ascertain if the bank's risk-management systems for its brokered and rate-sensitive deposits are adequate and if they are commensurate with the complexity of its liquidity and funding risks. Determine if the bank has the following:
    - proper funds-management policies;
    - adequate due diligence when assessing the risks associated with deposit brokers;
    - due diligence in assessing the potential risk to earnings and capital associated with brokered or other rate-sensitive deposits, and prudent strategies for their use;
    - reasonable control structures to limit funding concentrations;
    - management information systems (MIS) that clearly identify nonrelationship or higher-cost funding programs that allow management to track performance, manage funding gaps, and monitor compliance with concentration and other risk limits; and
    - contingency funding plans that address the risk that these deposits may

- not “roll over” and provide a reasonable alternative funding strategy.
- e. Review public funds and the bank’s method of acquiring such funds to assess whether the bank uses competitive bidding in setting the interest rate paid on public deposits. If so, does the bank consider variables in addition to rates paid by competition in determining pricing for bidding on public deposits?
  - f. Review appropriate trial balances for all other deposits (demand, savings, and other time deposits). Review management reports that relate to large deposits for individuals, partnerships, corporations, and related deposit accounts to determine whether a deposit concentration exists.
    - Select, at a minimum, the 10 largest accounts to determine if the retention of those accounts depends on—
      - criticizable loan relationships;
      - liberal service accommodations, such as permissive overdrafts and drawings against uncollected funds;
      - interbank correspondent relationships;
      - deposits obtained as a result of special promotions; and
      - a recognizable trend with respect to—
        - frequent significant balance fluctuations,
        - seasonal fluctuations, and
        - nonseasonal increases or decreases in average balances.
  - g. Elicit management’s comments to determine, to the extent possible—
    - the potential renewal of large CDs that mature within the next 12 months;
    - if public fund deposits have been obtained through political influence;
    - if a significant dollar volume of accounts is concentrated in customers engaged in a single business or industry; and
    - if there is a significant dollar volume of deposits from customers who do not reside within the bank’s service area.
15. Obtain information on competitive pressures and economic conditions and evaluate that information, along with current deposit trends, to estimate its effect on the bank’s deposit structure.
  16. Perform the following procedures to test for compliance with the applicable laws and regulations listed below:
    - a. *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks.* Review the overdraft listing to ensure that the bank has not paid an overdraft on any account of an executive officer or director, unless the payment is made according to—
      - a written, preauthorized, interest-bearing extension of a credit plan that provides a method of repayment, or
      - a written, preauthorized transfer from another account of that executive officer or director.
 Payment of inadvertent overdrafts in an aggregate amount of \$1,000 or less is not prohibited, provided the account is not overdrawn more than five business days and the executive officer or director is charged the same fee charged to other customers in similar circumstances. Overdrafts are extensions of credit and must be included when considering each insider’s lending limits and other extension-of-credit restrictions, as well as when considering the aggregate lending limit for all outstanding extensions of credit by the bank to all insiders and their related interests.
    - b. *12 USC 1972(2), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.* Review the overdraft listing to ensure that no preferential overdrafts exist from the bank under examination to the executive officers, directors, or principal shareholders of the correspondent bank.
    - c. *Section 22(e) of the Federal Reserve Act (12 USC 376), Interest on Deposits of Directors, Officers, and Employees.* Obtain a list of deposit accounts, with account numbers, of directors, officers, attorneys, and employees. Review the accounts for any exceptions to standard policies on service charges and interest rates paid that would suggest self-dealing or preferential treatment.
    - d. *Sections 23A and 23B of the Federal Reserve Act (12 USC 371c), and Regulation W.* Determine the existence of any non-intraday overdrawn affiliate accounts. If such overdrawn accounts are identified, review for compliance with



- sections 23A and 23B of the act and with Regulation W.
- e. *Regulation D (12 CFR 204), Reserve Requirements of Depository Institutions.* Review the accuracy of the deposit data used in the bank's reserve-requirement calculation for the examination date. When a bank issues nondeposit, uninsured obligations that are classified as "deposits" in the calculation of reserve requirements, examiners should determine if these items are properly categorized. Ascertain that the TT&L remittance option is included in the computations for reserve requirements.
  - f. *12 USC 501 and 18 USC 1004, False Certification of Checks.* Compare several certified checks by date, amount, and purchaser with the depositors' names appearing on uncollected-funds and overdraft reports of the same dates to determine that the checks were certified against collected funds.
  - g. *Uniform Commercial Code 4-108, Banking Hours and Processing of Items.*
    - Determine the bank's cutoff hour, after which items received are included in the processing for the next "banking day," to ensure that the cutoff hour is not earlier than 2:00 p.m.
    - If the bank's cutoff hour is before 2:00 p.m., advise management that failure to process items received before a 2:00 p.m. cutoff may result in civil liability for delayed handling of those items.
  - h. *Local escheat laws.* Determine if the bank is adhering to the local escheat laws with regard to all forms of dormant deposits, including official checks.
17. If applicable, determine if the bank is appropriately monitoring and limiting the foreign-exchange risk associated with foreign-currency deposits.
18. For a bank that accepts accounts from foreign governments, embassies, and political figures, evaluate—
    - a. the existence and effectiveness of the bank's policies, procedures, compliance oversight, and management reporting with regard to such foreign accounts;
    - b. whether the bank and its staff have the necessary controls, as well as the ability, to manage the risks associated with such foreign accounts;
    - c. whether the bank's board of directors and staff can ensure full compliance with its obligations under the Bank Secrecy Act, as amended by the USA Patriot Act, and its regulations;
    - d. the adequacy of the level of training of the bank's personnel responsible for managing the risks associated with such foreign accounts and for ensuring that the bank is and remains in compliance with the requirements of the applicable laws and regulations; and
    - e. the effectiveness of the bank's program that communicates its policies and procedures for such foreign accounts to ensure that foreign government, embassy, and political-figure customers are fully informed of the requirements of applicable U.S laws and regulations.
  19. Discuss overall findings with bank management. Prepare report comments on—
    - a. policy deficiencies,
    - b. noncompliance with policies,
    - c. weaknesses in supervision and reporting,
    - d. violations of laws and regulations, and
    - e. possible conflicts of interest.
  20. Update workpapers with any information that will facilitate future examinations.

# Deposit Accounts

## Internal Control Questionnaire

Effective date November 2004

## Section 3000.4

Review the bank's internal controls, policies, practices, and procedures for demand and time deposit accounts. The bank's systems should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

For large institutions or those institutions that have individual demand and time deposit book-keeping functions, the examiner should consider administering this questionnaire separately for each function, as applicable.

Questions pertain to both demand and time deposits unless otherwise indicated. Negative responses to the questions in this section should be explained, and additional procedures deemed necessary should be discussed with the examiner-in-charge. Items marked with an asterisk require substantiation by observation or testing.

### OPENING DEPOSIT ACCOUNTS

- \*1. Are new-account documents prenumbered?
  - a. Are new-account documents issued in strict numerical sequence?
  - b. Are the opening of new accounts and access to unused new-account records and certificate of deposit (CD) forms handled by an employee who is not a teller or who cannot make internal entries to customer accounts or the general ledger?
- \*2. Does the institution have a written "know-your-customer" policy?
  - a. Do new-account applications require sufficient information to clearly identify the customer?
  - b. Are "starter" checks issued only after the verification of data on new transaction-account applications?
  - c. Are checkbooks and statements mailed only to the address of record? If not, is a satisfactory explanation and description obtained for any other mailing address (post office boxes, a friend or relative, etc.)?
  - d. Are the employees responsible for opening new accounts trained to screen depositors for signs of check kiting?
- \*3. Does the bank perform periodic inven-

tories of new-account documents and CDs, and do the inventories include an accountability of numbers issued out of sequence or canceled prior to issuance?

- \*4. Are CDs signed by a properly authorized individual?
- 5. Are new-account applications and signature cards reviewed by an officer?

### CLOSING DEPOSIT ACCOUNTS

- 1. Are signature cards for closed accounts promptly pulled from the active-account file and placed in a closed file?
- 2. Are closed-account lists prepared? If so, how frequently?
- 3. Is the closed-account list circulated to appropriate management?
- 4. Is verification of closed accounts, in the form of statements of "goodwill" letters, required? Are such letters mailed under the control of someone other than a teller or an individual who can make internal entries to an account (such as a private banker or branch manager)?
- \*5. For redeemed CDs:
  - a. Are the CDs stamped paid?
  - b. Is the disposition of proceeds documented to provide a permanent record as well as a clear audit trail?
  - c. Are penalty calculations on CDs and on other time deposits that are redeemed before maturity rechecked by a second employee?
- \*6. Except for deposit-account agreements that authorize the transfer of deposited funds to other nondemand deposit accounts, are matured CDs that are not automatically renewable classified as demand deposits on the Call Report and on the Report of Transaction Accounts, Other Deposits and Vault Cash (FR 2900)?

### DEPOSIT-ACCOUNT RECORDS

- \*1. Does the institution have documentation supporting a current reconciliation of each deposit-account category recorded on its general ledger, including customer accounts



- and bank-controlled accounts such as dealer reserves, escrow, Treasury tax and loan, etc.? (Prepare separate workpapers for demand and time accounts, listing each account and the date and frequency of reconciliation, the general-ledger balance, the subsidiary-ledger balance, adjustments, and unexplained differences.)
- \*2. Are reconciliations performed by an individual or group not directly engaged in accepting or preparing transactions or in data entry to customers' accounts?
  - \*3. If the size of the bank precludes full separation of duties between data entry and reconciliation, are reconciliation duties rotated on a formal basis, and is a record maintained to support such action?
  - \*4. Are reconciliations reviewed by appropriate independent management, especially in circumstances when full separation of duties is not evident?
  - \*5. Are periodic reports prepared for management, and do the reports provide an aging of adjustments and differences and detail the status of significant adjustments and differences?
  - \*6. Has management adequately addressed any significant or long-outstanding adjustments or differences?
  - \*7. Is the preparation of input and the posting of subsidiary demand deposit records performed or adequately reviewed by persons who do not also—
    - a. accept or generate transactions?
    - b. issue official checks or handle funds-transfer transactions?
    - c. prepare or authorize internal entries (return items, reversals, and direct charges, such as loan payments)?
    - d. prepare supporting documents required for disbursements from an account?
    - e. perform maintenance on the accounts, such as changes of address, stop payments, holds, etc.?
  - \*8. Are in-process, suspense, interoffice, and other accounts related to deposit accounts controlled or closely monitored by persons who do not have posting or reconciliation duties?
  - \*9. Are periodic reports prepared for management on open items in suspense and on in-process, interoffice, overdrawn, and other deposit accounts, and do the reports include aging of items and the status of significant items?
  - 10. If the bank's bookkeeping system is not automated, are deposit bookkeepers rotated?
  - 11. Does the bank segregate the deposit account files of—
    - a. employees and officers?
    - b. directors?
    - c. the business interests of employees and officers, or interests controlled by employees and officers?
    - d. the business interests of directors, or interests controlled by directors?
    - e. foreign governments, embassies, and political figures?
  - \*12. Are posting and check filing separated from statement preparation?
  - 13. Are statements mailed or delivered to all customers as required by the bank's deposit-account agreement?
  - \*14. Are customer transaction and interest statements mailed in a controlled environment that precludes any individual from receiving any statement not specifically authorized by the customer or the institution's policy (for example, dormant-account statements)?

## DORMANT ACCOUNTS AND RETURNED MAIL

- \*1. Does the bank have formal policies and procedures for the handling of customers' transaction and interest statements that are returned as undeliverable? Does the policy—
  - a. require that statements be periodically mailed on dormant accounts? If so, how often?
  - b. prohibit the handling of dormant-account statements by (1) employees of the branch where the account is assigned, (2) the account officer, and (3) other individuals with exclusive control of accounts?
  - c. require positive action to follow up on obtaining new addresses?
  - d. place statements and signature cards for accounts for which contact cannot be re-established (the mail is returned more than once or is marked "deceased") into a controlled environment?
  - e. require the bank to change the address on future statements to the department

- of the bank (the controlled environment) designated to receive returned mail?
- f. require a written request from the customer and verification of the customer's signature before releasing an account from the controlled environment?
- \*2. Are accounts for which contact cannot be re-established and that do not reflect recent activity removed from active files and clearly classified as dormant?
  - \*3. Before returning a dormant account to active status, are transactions reactivating the account verified, and are independent confirmations obtained directly from the customer?
  - \*4. Does transfer from dormant to active status require the approval of an officer who cannot approve transactions on dormant accounts?
    - c. require the customer to sign a statement describing the purpose of the request and the proposed times for pickup, and designate the individuals authorized to pick up the statement?
    - d. require the maintenance of signature cards for individuals authorized to pick up statements, and compare the authorized signatures with those who sign for statements held for pickup?
    - e. prohibit the delivery of statements to officers and employees requiring special attention unless it is part of the formal "hold-mail" function?
- \*2. Is a central record of hold-mail arrangements maintained in a control area that does not originate entries to customers' accounts? Does the record identify each hold-mail arrangement, the designated location for pickup, and the scheduled pickup times? Does the control area—
    - a. maintain current signature cards of individuals authorized to pick up statements?
    - b. obtain signed receipts showing the date of pickup, and compare the receipts with the signature cards?
    - c. follow up on the status of statements not picked up as scheduled?
  - \*3. Does management review activity in hold-mail accounts that have not been picked up for extended periods of time (for example, one year), and, when there is no activity, place the accounts in a dormant status?

## INACTIVE ACCOUNTS

1. Are demand accounts that have been inactive for one year, and time accounts that have been inactive for three years, classified as inactive? If not, state the time period for classifying a demand or time account as inactive.
2. Does the bank periodically review the inactive accounts to determine if they should be placed in a dormant status, and are decisions to keep such accounts in active files documented?

## HOLD MAIL

- \*1. Does the institution have a formal policy and procedure for handling statements and documents that a customer requests not to be mailed but that will be picked up at a location within the institution? Does the policy—
  - a. require that statements will not be held by an individual (an account officer, branch manager, bookkeeper, etc.) who could establish exclusive control over entries to and the delivery of statements for customer accounts?
  - b. discourage such pickup arrangements and grant them only after the customer provides a satisfactory reason for the arrangement?

## OVERDRAFTS

- \*1. Are overdraft authorization limits for officers formally established?
- \*2. Does the bank require an authorized officer to approve overdrafts?
- \*3. Is an overdraft listing prepared daily for demand deposit and time transaction accounts?
  4. For banks processing overdrafts that are not automatically approved (a "pay none" system), is the nonsufficient-funds report circulated among bank officers?
- \*5. Are overdraft listings circulated among the officers?
6. Are the statements of accounts with large overdrafts reviewed for irregularities and prompt repayment?

7. Is an aged record of large overdrafts included in the monthly report to the board of directors or its committee, and does the report include the overdraft origination date?
8. Is there an established schedule of service charges?
  - capacity to manage those risks?

## UNCOLLECTED FUNDS

- \*1. Does the institution generate a daily report of drawings against uncollected funds for demand deposit and time transaction accounts?
  - a. Is the computation of uncollected funds positions based on reasonable check-collection criteria?
  - b. Can the reports, or a separate account activity report, be used to detect potential kiting conditions?
  - c. If reports are not generated for time transaction accounts, is a system in place to control drawings against uncollected funds?
- \*2. Do authorized officers review the uncollected-funds reports and approve drawings against uncollected funds within established limits?
- \*3. Are accounts that frequently appear on the uncollected-funds or kite-suspect reports reviewed regardless of account balances? (For example, accounts with simultaneous large debits and credits can reflect low balances.)

## ACCOUNTS FOR FOREIGN GOVERNMENTS, EMBASSIES, AND POLITICAL FIGURES

1. For bank relationships with a foreign government, embassy, or political figure:
    - a. Has the board of directors established standards and guidelines for management to use when evaluating whether or not the bank should accept such new accounts?
    - b. Are the standards and guidelines consistent with the bank's—
      - own business objectives,
      - assessment of the varying degrees of risks associated with particular foreign accounts or lines of business, and
- c. Does the bank have adequate internal controls and compliance oversight systems to monitor and manage the varying degrees of risks associated with such foreign accounts? Do these internal controls and compliance systems ensure full compliance with the Bank Secrecy Act, as amended by the USA Patriot Act, and its respective regulations?
  - d. Does the bank have personnel that are sufficiently trained in the management of such risks and in the requirements of applicable laws and regulations?
  - e. Does the bank have policies and procedures for ensuring that such foreign-account customers receive adequate communications from the bank? Communications should ensure that these customers are made fully aware of the requirements of U.S. laws and regulations to which the bank is subject.
  - f. Does the bank seek to structure its relationships with such foreign-account customers so as to minimize the varying degrees of risks these customers may pose?

## OTHER MATTERS

- \*1. Are account-maintenance activities (changes of address, status changes, rate changes, etc.) separated from data entry and reconciling duties?
- \*2. Do all internal entries other than service charges require the approval of appropriate supervisory personnel?
- \*3. If not included in the internal or external audit program, are employees' and officers' accounts, accounts of employees' and officers' business interests, and accounts controlled by employees and officers periodically reviewed for unusual or prohibited activity?
- \*4. For unidentified deposits:
  - a. Are deposit slips kept under dual control?
  - b. Is the disposition of deposit slips approved by an appropriate officer?
- \*5. For returned checks, unposted items, and

- other rejects:
- a. Are daily listings of such items prepared?
  - b. Are all items reviewed daily, and is disposition of items required within a reasonable time period? If so, indicate the time period.
  - c. Are reports prepared for management that show items not disposed of within the established time frames?
6. Are customers immediately notified in writing of deposit errors?
  7. Does the bank require a customer's signature for stop-payment orders?
  8. For automatic transfer accounts:
    - a. Are procedures in effect that require officer approval for transfers in excess of the savings balance?
    - b. For nonautomated systems, are transfers made by employees who do not also handle cash, execute external funds transfers, issue official checks singly, or post subsidiary records?
  9. For telephone transfer accounts:
    - a. Do depositors receive an individual identification code for use in making transfers?
    - b. Are transfers made by employees who do not also handle cash, execute external funds transfers, issue official checks singly, or post subsidiary records?
  - \*10. If not included in the internal or external audit program, are accrual balances for the various types of deposits verified periodically by an authorized official? If so, indicate how often.
  - \*11. Are accounts with a "hold-balance" status—those accounts on which court orders have been placed, those pledged as security to customers' loans, those pending the clearing of a large check, those for which the owner is deceased, and those for which the passbook has been lost—"locked out" for transactions unless the transaction is approved by appropriate management?
  12. For passbook accounts:
    - a. Do all entries to passbooks contain teller identification?
    - b. Under a window-posting system, are recording media and passbooks posted simultaneously?
    - c. Are tellers prohibited from holding customers' savings passbooks?
    - d. If customers' passbooks are held, are they maintained under the institution's "hold-mail" program and kept under dual control?
  - e. Are customers prohibited from withdrawing funds without a passbook? If not, state the policy.
  13. For withdrawals from savings or other time accounts:
    - a. Are withdrawal tickets canceled daily?
    - b. Are procedures in place to preclude overdrafts?
    - c. Are procedures in effect to place holds on, and to check for holds on, withdrawals over a stated amount? If so, indicate the amount.
  14. For signature cards on demand and time accounts:
    - a. Are procedures in effect to guard against the substitution of false signatures? Describe the procedures.
    - b. Are signature cards stored to preclude physical damage?
    - c. Are signatures compared for withdrawals and cashed checks? Describe the procedures.

## OFFICIAL CHECKS, MONEY ORDERS, AND CERTIFIED CHECKS

- \*1. Are separate general-ledger accounts maintained for each type of official check?
- \*2. For each type of check issued:
  - a. Are multicopy checks and certified-check forms used? If not, are detailed registers of disbursed checks maintained?
  - b. Are all checks prenumbered and issued in sequence?
  - c. Is check preparation and issuance separate from recordkeeping?
  - d. Is the signing of checks in advance prohibited?
  - e. Do procedures prohibit the issuance of a check before the credit is processed?
- \*3. Is the list authorizing bank personnel to sign official checks kept current? Does the list include changes in authorization limits, delete employees who no longer work at the bank, and indicate employees added to the list?
- \*4. Are appropriate controls in effect over check-signing machines (if used) and certification stamps?

- \*5. Are voided checks and voided certified-check forms promptly defaced and filed with paid checks?
- \*6. If reconcilements are not part of the overall deposit-reconciliation function—
  - a. are outstanding checks listed and reconciled regularly to the general ledger? If so, state how often.
  - b. is permanent evidence of reconcilements maintained?
  - c. is there clear separation between the preparation of checks, data entry, and check reconciliation?
  - d. are the reconcilements reviewed regularly by an authorized officer?
  - e. are reconcilment duties rotated on a formal basis in institutions where size precludes the full separation of duties between data entry and reconcilment?
  - f. are authorized signatures and endorsements checked by the filing clerk?
- \*7. For supplies of official checks:
  - a. Are records of unissued official checks maintained centrally and at each location storing them?
  - b. Are periodic inventories of unissued checks independently performed?
  - c. Do the inventories include a description of all checks issued out of sequence?
  - d. If users are assigned a supply, is that supply replenished on a consignment basis?
- \*8. Are procedures in effect to preclude certification of checks drawn against uncollected funds?

## TREASURY TAX AND LOAN ACCOUNTS (31 CFR 203)

1. Do transfers from the remittance-option account to the Federal Reserve Bank occur the next business day after deposit?
2. When the note option is used, do transfers from the Treasury Tax and Loan (TT&L) demand deposit account occur the next

business day after deposit?

- \*3. Has the TT&L-account reconciliation been completed in a timely manner and approved by a supervisor?
- 4. Has adequate collateral been pledged to secure the TT&L account?

## AUDIT

- \*1. Are deposit-account activities audited on a sufficiently frequent basis?
- \*2. Does the scope of the audit program require, and do audit records support, substantive testing or quantitative measurements of deposit-account activities that, at a minimum, include the matters set forth in this questionnaire?
- \*3. Does the audit program include a comprehensive confirmation program with the customers of each deposit category maintained by the institution?
- \*4. Do audit department records support the execution of the confirmation program, and do the records reflect satisfactory follow-up of responses and of requests returned as undeliverable?
- \*5. Are audit and prior-examination recommendations for deposit-account activities appropriately addressed?

## CONCLUSION

- \*1. Does the foregoing information provide an adequate basis for evaluating internal control in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
- \*2. Are internal controls adequate on the basis of a composite evaluation, as evidenced by answers to the foregoing questions?

Borrowed funds are a common and practical method for banks of all sizes to meet customers' needs and enhance banking operations. For the purposes of this section, borrowings exclude long-term subordinated debt, such as capital notes and debentures (discussed in "Assessment of Capital Adequacy," section 3020.1). Borrowings may exist in a number of forms, both on a direct and indirect basis. Common sources of direct bank borrowings include Federal Home Loan Bank credit lines, federal funds purchased, loans from correspondent banks, repurchase agreements, negotiable certificates of deposit, and borrowings from the Federal Reserve discount window. These are discussed in some detail below. Other borrowings include bills payable to the Federal Reserve, interest-bearing demand notes issued to the U.S. Treasury (the Treasury tax and loan note option account), mortgages payable, due bills, and other types of borrowed securities. Indirect forms of borrowings include customer paper rediscounted and assets sold with the bank's endorsement or guarantee or subject to a repurchase agreement.

The primary reasons a bank may borrow include the following:

- To meet the temporary or seasonal loan or deposit withdrawal needs of its customers, if the borrowing period is temporary and the bank is quickly restored to a position in which the quantity of its principal earning assets and cash reserves is in proper relation to the requirements of its normal deposit volume.
- To meet large and unanticipated deposit withdrawals that may arise during periods of economic distress. The examiner should distinguish between "large and unanticipated deposit withdrawals" and a predeterminable contraction of deposits, such as the cessation of activities in a resort community or the withdrawal of funds on which the bank received adequate prior withdrawal notice. Those situations should be met through ample cash reserves and readily convertible assets rather than borrowing.
- To manage liabilities effectively. Generally, the effective use of this type of continuous borrowing is limited to money-center or large regional banks.

It is important to analyze each borrowing on

its own merit to determine its purpose, effectiveness, and stability. Some of the more frequently used sources of borrowings are discussed below.

### COMMON SOURCES OF BORROWINGS

#### Federal Home Loan Bank Borrowings

The Federal Home Loan Bank (FHLB) originally served solely as a source of borrowings to savings and loan companies. With the implementation of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), FHLB's lending capacity was expanded to include banks.

Compared with borrowings from the discount window of the Reserve Banks, borrowings from the FHLB have fewer conditions. Both short-term and long-term borrowings, with maturities ranging from overnight to 30 years, are available to institutions at generally competitive interest rates. The flexibility of the facility enables bank management to use this source of funds for the purpose of asset/liability management, and it allows management to secure a favorable interest-rate spread. For example, FHLB borrowings may provide a lower-cost alternative to the conventional deposit, particularly in a highly competitive local market.

Management should be capable of explaining the purpose of the borrowing transaction. The borrowing transaction should then be analyzed to determine whether the arrangement achieved the stated purpose or whether the borrowings are a sign of liquidity deficiencies. Further, the borrowing agreement between the institution and the FHLB should be reviewed to determine the asset collateralizing the borrowings and the potential risks presented by the agreement. In some instances, the borrowing agreement may provide for collateralization by all assets not already pledged for other purposes.

The types of collateral necessary to obtain an FHLB loan include residential mortgage loans and mortgage-backed securities. The composite rating of an institution is a factor in both the approval for obtaining an FHLB loan and the level of collateral required.

## Federal Funds Purchased

The day-to-day use of federal funds is a rather common occurrence, and federal funds are considered an important money market instrument. Many regional and money-center banks, acting in the capacity of correspondents to smaller community banks, function as both providers and purchasers of federal funds and, in the process of these transactions, often generate a small return.

A brief review of bank reserves is essential to a discussion of the federal funds market. As a condition of membership in the Federal Reserve System, member banks are required to maintain a portion of their deposits as reserves. Reserves can take the form of vault cash and deposits in the Reserve Bank. The amount of these reserve balances is reported weekly or quarterly and computed on the basis of the daily average deposit balances. For institutions that report their reserves on a weekly basis, required reserves are computed on the basis of daily average balances of deposits and Eurocurrency liabilities during a 14-day period ending every second Monday. Institutions that report their reserves on a quarterly basis compute their reserve requirement on the basis of their daily average deposit balances during a seven-day computation period that begins on the third Tuesday of March, June, September, and December. (See 12 CFR 204.3(c)–(d).)

Since member banks do not receive interest on the reserves, banks prefer to keep excess balances at a minimum to achieve the maximum utilization of funds. To accomplish this goal, banks carefully analyze and forecast their daily reserve position. Changes in the volume of required reserves occur frequently as the result of deposit fluctuations. Deposit increases require member banks to maintain more reserves; conversely, deposit decreases require less reserves.

The most frequent type of federal funds transaction is unsecured for one day and repayable the following business day. The rate is usually determined by overall money market rates as well as by the available supply of and demand for funds. In some instances, when the selling and buying relationship between two banks is quite continuous, something similar to a line of credit may be established on a funds-availability basis. Although the most common federal funds transaction is unsecured, the selling of funds can also be secured and for longer

periods of time. Agency-based federal funds transactions are discussed in “Bank Dealer Activities,” section 2030.1.

## Loans from Correspondent Banks

Small and medium-sized banks often negotiate loans from their principal correspondent banks. The loans are usually for short periods and may be secured or unsecured.

## Repurchase Agreements

The terms “repurchase agreement”<sup>1</sup> (repo) and “reverse repurchase agreement” refer to a type of transaction in which a money market participant acquires immediately available funds by selling securities and simultaneously agreeing to repurchase the securities after a specified time at a given price, which typically includes interest at an agreed-on rate. Such a transaction is called a repo when viewed from the perspective of the supplier of the securities (the borrower), and a reverse repo or matched sale-purchase agreement when described from the point of view of the supplier of funds (the lender).

Frequently, instead of resorting to direct borrowings, a bank may sell assets to another bank or some other party and simultaneously agree to repurchase the assets at a specified time or after certain conditions have been met. Bank securities as well as loans are often sold under a repo to generate temporary working funds. These kind of agreements are often used because the rate on this type of borrowing is less than the rate on unsecured borrowings, such as federal funds purchased.

The usual terms for the sale of securities under a repo require that, after a stated period of time, the seller repurchase the securities at a predetermined price or yield. A repo commonly includes a near-term maturity (overnight or a few days) and is usually arranged in large-dollar amounts. The lender or buyer is entitled to receive compensation for use of the funds provided to its counterparty. The interest rate paid on a repo is negotiated based on the rates on the underlying securities. U.S. government and agency securities are the most common type of

1. See sections 2015.1, 2020.1, and 4170.1.

instruments sold under repurchase agreements, since those types of repos are exempt from reserve requirements.

Although standard overnight and term repo arrangements in Treasury and federally related agency securities are most prevalent, market participants sometimes alter various contract provisions to accommodate specific investment needs or to provide flexibility in the designation of collateral. For example, some repo contracts allow substitutions of the securities subject to the repurchase commitment. These are called “dollar repurchase agreements” (dollar rolls), and the initial seller’s obligation is to repurchase securities that are substantially similar, but not identical, to the securities originally sold. Another common repo arrangement is called a “flex repo,” which, as implied by the name, provides a flexible term to maturity. A flex repo is a term agreement between a dealer and a major customer in which the customer buys securities from the dealer and may sell some of them back before the final maturity date.

Bank management should be aware of certain considerations and potential risks of repurchase agreements, especially when entering into large-dollar-volume transactions with institutional investors or brokers. Both parties in a term repo arrangement are exposed to interest-rate risk. It is a fairly common practice to have the collateral value of the underlying securities adjusted daily to reflect changes in market prices and to maintain the agreed-on margin. Accordingly, if the market value of the repo securities declines appreciably, the borrower may be asked to provide additional collateral. Conversely, if the market value of the securities rises substantially, the lender may be required to return the excess collateral to the borrower. If the value of the underlying securities exceeds the price at which the repurchase agreement was sold, the bank could be exposed to the risk of loss if the buyer is unable to perform and return the securities. This risk would obviously increase if the securities are physically transferred to the institution or broker with which the bank has entered into the repurchase agreement. Moreover, if the securities are not returned, the bank could be exposed to the possibility of a significant write-off, to the extent that the book value of the securities exceeds the price at which the securities were originally sold under the repurchase agreement. For this reason, banks should avoid pledging excessive collateral and obtain sufficient financial information on and analyze the

financial condition of those institutions and brokers with whom they engage in repurchase transactions.

“Retail repurchase agreements” (retail repos)<sup>2</sup> for a time were a popular vehicle for some commercial banks to raise short-term funds and compete with certain instruments offered by nonbanking competitors. For booking purposes, a retail repo is a debt incurred by the issuing bank that is collateralized by an interest in a security that is either a direct obligation of or guaranteed as to principal and interest by the U.S. government or an agency thereof. Retail repos are issued in amounts not exceeding \$100,000 for periods of less than 90 days. With the advent of money market certificates issued by commercial banks, the popularity of the retail repo declined.

Both retail and large-denomination, wholesale repurchase agreements are in many respects equivalent to short-term borrowings at market rates of interest. Therefore, banks engaging in repurchase agreements should carefully evaluate their interest-rate-risk exposure at various maturity levels, formulate policy objectives in light of the institution’s entire asset and liability mix, and adopt procedures to control mismatches between assets and liabilities. The degree to which a bank borrows through repurchase agreements also should be analyzed with respect to its liquidity needs, and contingency plans should provide for alternative sources of funds.

## Negotiable Certificates of Deposit

Certificates of deposit (CDs) have not been legally defined as borrowings and continue to be reflected as deposits for reporting purposes. However, the fundamental distinction between a negotiable money market CD as a deposit or as a borrowing is nebulous at best; in fact, the negotiable money market CD is widely recognized as the primary borrowing vehicle for many banks. Dependence on CDs as sources of funds is discussed in “Deposit Accounts,” section 3000.1.

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2. See sections 2015.1, 2020.1, and 4170.1.



## Borrowings from the Federal Reserve

In accordance with the Board's Regulation A (12 CFR 201), the Federal Reserve Banks generally make credit available through the primary, secondary, and seasonal credit programs to any depository institution that maintains transaction accounts or nonpersonal time deposits.<sup>3</sup> However, the Federal Reserve expects depository institutions to rely on market sources of funds for their ongoing funding needs and to use these credit programs as a backup source of funding rather than a routine one. An institution that borrows primary credit may use those funds to finance sales of federal funds, but secondary and seasonal credit borrowers may not act as the medium or agent of another depository institution in receiving Federal Reserve credit except with the permission of the lending Federal Reserve Bank.

A Federal Reserve Bank is not obligated to extend credit to any depository institution but may lend to a depository institution either by making an advance secured by acceptable collateral or by discounting certain types of paper described in the Federal Reserve Act. Although Reserve Banks now always extend credit in the form of an advance, the Federal Reserve's credit facility nonetheless is known colloquially as the "discount window." Before lending to a depository institution, a Reserve Bank can require any information it believes is appropriate to ensure that the assets tendered as collateral are acceptable. A Reserve Bank also should determine prior to lending whether the borrowing institution is undercapitalized or critically undercapitalized. Operating Circular No. 10, "Lending," establishes the credit and security terms for borrowings from the Federal Reserve.

3. In unusual and exigent circumstances and after consultation with the Board, a Reserve Bank may extend credit to individuals, partnerships, and corporations that are not depository institutions if, in the judgment of the Reserve Bank, credit is not available from other sources and failure to obtain credit would adversely affect the economy. A Reserve Bank may extend credit to a nondepository entity in the form of an advance only if the advance is secured by a direct obligation of the United States or a direct obligation of, or an obligation that is fully guaranteed as to principal and interest by, any agency of the United States. An extension of credit secured by any other type of collateral must be in the form of a discount and must be authorized by an affirmative vote of at least five members of the Board.

## Primary Credit

Reserve Banks may extend primary credit on a very short term basis (typically overnight) to depository institutions that the Reserve Banks judge to be in generally sound financial condition. Reserve Banks extend primary credit at a rate above the target federal funds rate of the Federal Open Market Committee. Minimal administrative requirements apply to requests for overnight primary credit, unless some aspect of the credit request appears inconsistent with the conditions of primary credit (for example, if a pattern of behavior indicates strongly that an institution is using primary credit other than as a backup source of funding). Reserve Banks also may extend primary credit to eligible institutions for periods of up to several weeks if such funding is not available from other sources. However, longer-term extensions of primary credit will be subject to greater administration than are overnight loans.

Reserve Banks determine eligibility for primary credit according to a uniform set of criteria that also is used to determine eligibility for daylight credit under the Board's Policy Statement on Payments System Risk. These criteria are based mainly on examination ratings and capitalization, although Reserve Banks also may use supplementary information, including market-based information when available. Specifically, an institution that is at least adequately capitalized and rated CAMELS 1 or 2 (or SOSA 1 and ROCA 1, 2, or 3) almost certainly would be eligible for primary credit. An institution that is at least adequately capitalized and rated CAMELS 3 (or SOSA 2 and ROCA 1, 2, or 3) generally would be eligible. An institution that is at least adequately capitalized and rated CAMELS 4 (or SOSA 1 or 2 and ROCA 4 or 5) would be eligible only if an ongoing examination indicated a substantial improvement in condition. An institution that is not at least adequately capitalized, or that is rated CAMELS 5 (or SOSA 3 regardless of the ROCA rating), would not be eligible for primary credit.

## Secondary Credit

Secondary credit is available to institutions that do not qualify for primary credit. Secondary credit is available as a backup source of liquidity on a very short term basis, provided that the loan is consistent with a timely return to a reliance on

market sources of funds. Longer-term secondary credit is available if necessary for the orderly resolution of a troubled institution, although any such loan would have to comply with additional requirements for lending to undercapitalized and critically undercapitalized institutions. Unlike the primary credit program, secondary credit is not a minimal administration facility because Reserve Banks must obtain sufficient information about a borrower's financial situation to ensure that an extension of credit complies with the conditions of the program. Secondary credit is available at a rate above the primary credit rate.

### *Seasonal Credit*

Seasonal credit is available under limited conditions to meet the needs of depository institutions that have seasonal patterns of movement in deposits and loans but that lack ready access to national money markets. In determining a depository institution's eligibility for seasonal credit, Reserve Banks consider not only the institution's historical record of seasonal fluctuations in loans and deposits, but also the institution's recent and prospective needs for funds and its liquidity conditions. Generally, only very small institutions with pronounced seasonal funding needs will qualify for seasonal credit. Seasonal credit is available at a flexible rate that takes into account the rate for market sources of funds.

### *Collateral Requirements*

All loans advanced by the Reserve Bank must be secured to the satisfaction of the Reserve Bank. Collateral requirements are governed by Operating Circular No. 8. Reserve Banks require a perfected security interest in all collateral pledged to secure loans. Satisfactory collateral generally includes U.S. government and federal-agency securities, and, if they are of acceptable quality, mortgage notes covering one- to four-family residences; state and local government securities; and business, consumer, and other customer notes. Traditionally, collateral is held in the Reserve Bank vault. Under certain circumstances, collateral may be retained on the borrower's premises under a borrower-in-custody arrangement, or it may be held on the borrower's premises under the Reserve Bank's exclusive custody and control in a field ware-

house arrangement. Collateral may also be held at the borrowing institution's correspondent or another third party. All book-entry collateral must be held at the Federal Reserve Bank. Definitive collateral, not in bearer form, must be properly assigned and endorsed.

### *Lending to Undercapitalized and Critically Undercapitalized Depository Institutions*

Credit from any Reserve Bank to an institution that is "undercapitalized" may be extended or outstanding for no more than 60 days during which the institution is undercapitalized in any 120-day period.<sup>4</sup> An institution is considered undercapitalized if it is not critically undercapitalized under section 38 of the Federal Deposit Insurance Act (the FDI Act) but is either deemed undercapitalized under that provision and its implementing regulations or has received a composite CAMELS rating of 5 as of the most recent examination. A Reserve Bank may make or have outstanding advances or discounts to an institution that is deemed "critically undercapitalized" under section 38 of the FDI Act and its implementing regulations only during the five-day period beginning on the date the institution became critically undercapitalized or after consultation with the Board.

## INTERNATIONAL BORROWINGS

International borrowings may be direct or indirect. Common forms of direct international borrowings include loans and short-term call money from foreign banks, borrowings from the Export-Import Bank of the United States, and overdrawn nostro (due from foreign banks—demand) accounts. Indirect forms of borrowing include notes and trade bills rediscounted with the central banks of various countries; notes, acceptances, import drafts, or trade bills sold with the bank's endorsement or guarantee; notes and other obligations sold subject to repurchase agreements; and acceptance pool participations.

4. Generally, a Reserve Bank also may lend to an undercapitalized institution during 60 calendar days after receipt of a certificate of viability from the Chairman of the Board of Governors or after consultation with the Board.

## ANALYZING BORROWINGS

If a bank borrows extensively or in large amounts, the examiner should thoroughly analyze the borrowing activity. An effective analysis includes a review of the bank's reserve records, both required and maintained, to determine the frequency of deficiencies at the closing of reserve periods. The principal sources of borrowings, range of amounts, frequency, length of time indebted, cost, and reasons for the borrowings should be explored. The actual use of the funds should be verified.

Examiners should also analyze changes in a bank's borrowing position for signs of deterioration in its borrowing ability and overall creditworthiness. One indication of deterioration is the payment of large fees to money brokers to obtain funds because the bank is having difficulty obtaining access to conventional sources of borrowings. These "brokered deposits" are usually associated with small banks since they

do not generally have ready access to alternative sources of funds available to larger institutions through the money and capital markets. Brokered deposits generally carry higher interest rates than alternative sources, and they tend to be particularly susceptible to interest-rate changes in the overall financial market. For further discussion of brokered deposits, see "Deposit Accounts," section 3000.1.

Other indicators of deterioration in a bank's borrowing ability and overall creditworthiness include, but are not limited to, requests for collateral on previously unsecured credit lines or increases in collateral margins, the payment of above-market interest rates, or a shortening of maturities that is inconsistent with management's articulated balance-sheet strategies. If the examiner finds that a bank's borrowing position is not properly managed, appropriate comments should be included in the report of examination.

# Borrowed Funds

## Examination Objectives

Effective date May 1996

## Section 3010.2

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

# Borrowed Funds

## Examination Procedures

Effective date October 2008

## Section 3010.3

1. If selected for implementation, complete or update the Borrowed Funds section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by the internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any audit deficiencies noted in the latest review done by internal/external auditors from the examiner assigned to “Internal Control” and determine if appropriate corrections have been made.
4. Obtain the listing of accounts related to domestic and international borrowed funds from the examiner assigned to “Examination Strategy.”
5. Prepare or obtain a listing of borrowings, by type, and—
  - a. agree or reconcile balances to department controls and general ledger, and
  - b. review reconciling items for reasonableness.
6. From consultation with the examiners assigned to the various loan areas, determine that the following schedules were reviewed in the lending departments and that there was no endorsement, guarantee, or repurchase agreement which would constitute a borrowing:
  - a. participations sold
  - b. loans sold in full since the preceding examination
7. Based on the information obtained in steps 5 and 6, and through observation and discussion with management and other examining personnel, determine that all borrowings are properly reflected on the books of the bank.
8. If the bank engages in any form of borrowing which requires written borrowing agreement(s), complete the following:
  - a. Prepare or update a carry-forward workpaper describing the major terms of each borrowing agreement, and determine that the bank is complying with those terms.
  - b. Review terms of past and present borrowing agreements for indications of deteriorating credit position by noting—
    - recent substantive changes in borrowing agreements,
    - increases in collateral to support borrowing transactions,
    - general shortening of maturities,
    - interest rates exceeding prevailing market rates,
    - frequent changes in lenders, and
    - large fees paid to money brokers.
  - c. If the bank has obtained funds from money brokers (brokered deposits), determine—
    - why such deposits were originally obtained,
    - who the deposits were obtained from,
    - what the funds are used for,
    - the relative cost of brokered deposits in comparison to alternate sources of funds, and
    - the overall effect of the use of brokered deposits on the bank’s condition and whether there appear to be any abuses related to the use of such deposits.
  - d. If there is an indication that the bank’s credit position has deteriorated, ascertain why.
9. If the bank engages in the issuance of retail repurchase agreements (retail repos), check for compliance with section 4170.1; also 2015.1 and 2020.1.
10. Determine the purpose of each type of borrowing and conclude whether the bank’s borrowing posture is justified in light of its financial condition and other relevant circumstances.
11. Provide the examiner assigned to “Asset/Liability Management” the following information:
  - a. A summary and an evaluation of the bank’s borrowing policies, practices, and procedures. The evaluation should give consideration to whether the bank—
    - evaluates interest-rate-risk exposure at various maturity levels;
    - formulates policy objectives in light of the entire asset and liability mix, and liquidity needs;
    - has adopted procedures to control mis-

- matches between assets and liabilities; and
  - has contingency plans for alternate sources of funds in the event of a run-off of current funding sources.
- b. An evaluation of the bank's adherence to established policies and procedures.
  - c. A repricing maturity schedule of borrowings.
  - d. A listing of prearranged federal funds lines and other lines of credit. Indicate the amount currently available under those lines, i.e., the unused portion of the lines.
  - e. The amount of any anticipated decline in borrowings over the next \_\_\_\_\_ day period. (The time period will be determined by the examiner assigned to "Asset/Liability Management.")
12. Prepare a list of all borrowings by category, on a daily basis for the period since the last examination. Also, include on the list short-term or overnight money market lending activities such as federal funds sold and securities purchased under resale agreement. For each category on the list, compute for the period between examinations—
    - a. high point
    - b. low point
    - c. average amounts outstanding
    - d. frequency of borrowing and lending activity, expressed in terms of number of days
  13. Prepare, in appropriate report form, and discuss with appropriate management—
    - a. the adequacy of written policies regarding borrowings;
    - b. the manner in which bank officers are operating in conformance with established policy;
    - c. the existence of any unjustified borrowing practices;
    - d. any violation of laws or regulations; and
    - e. recommended corrective action when policies, practices, or procedures are deficient; violations of laws or regulations exist; or when unjustified borrowing practices are being pursued.
  14. Update the workpapers with any information that will facilitate future examinations.
  15. Review the market value of collateral and collateral-control arrangements for repurchase agreements to ensure that excessive collateral has not been pledged and that the bank is not exposed to excessive credit risks.

# Borrowed Funds

## Internal Control Questionnaire

Effective date March 1984

## Section 3010.4

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

### POLICY

1. Has the board of directors approved a written policy which:
  - a. Outlines the objectives of bank borrowings?
  - b. Describes the bank's borrowing philosophy relative to risk considerations, i.e., leverage/growth, liquidity/income?
  - c. Provides for risk diversification in terms of staggered maturities rather than solely on cost?
  - d. Limits borrowings by amount outstanding, specific type or total interest expense?
  - e. Limits or restricts execution of borrowings by bank officers?
  - f. Provides a system of reporting requirements to monitor borrowing activity?
  - g. Requires subsequent approval of transactions?
  - h. Provides for review and revision of established policy at least annually?

### RECORDS

- \*2. Does the bank maintain subsidiary records for each type of borrowing, including proper identification of the obligee?
- \*3. Is the preparation, addition and posting of the subsidiary borrowed funds records performed or adequately reviewed by persons who do not also:
  - a. Handle cash?
  - b. Issue official checks and drafts?

- c. Prepare all supporting documents required for payment of debt?
- \*4. Are subsidiary borrowed funds records reconciled with the general ledger accounts at an interval consistent with borrowing activity, and are the reconciling items investigated by persons, who do not also:
  - a. Handle cash?
  - b. Prepare or post to the subsidiary borrowed funds records?

### INTEREST

- \*5. Are individual interest computations checked by persons who do not have access to cash?
6. Is an overall test of the total interest paid made by persons who do not have access to cash?
7. Are payees on the checks matched to related records of debt, note or debenture owners?
8. Are corporate resolutions properly prepared as required by creditors and are copies on file for reviewing personnel?
9. Are monthly reports furnished to the board of directors reflecting the activity of borrowed funds, including amounts outstanding, interest rates, interest paid to date and anticipated future activity?

### CONCLUSION

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

Commercial banks rely on wholesale borrowings obtained from a number of financial intermediaries, including Federal Home Loan Banks, other commercial banks, and securities firms. These borrowings frequently have attractive features and pricing. If properly assessed and prudently managed, they can enhance a bank's funding options and assist in controlling interest-rate and liquidity risks. Some of the reasons that banks use these types of borrowings include the initial low cost of funds when compared with other liabilities with similar maturities. At the same time, certain wholesale borrowings have become more complex, and some structures include various types of embedded options.<sup>1</sup> If not thoroughly assessed and prudently managed, these more complex funding instruments have the potential over time to significantly increase a bank's sensitivity to market and liquidity risks. Maturity mismatches or the embedded options themselves can, in some circumstances, adversely affect a bank's financial condition, especially when the terms and conditions of the borrowings are misunderstood.

A growing use of wholesale borrowings, combined with the risks associated with the complex structures of some of these borrowings, makes it increasingly important for bank supervisors to assess the risks and risk-management processes associated with these sources of funds. The supervisory guidance provided below supplements and expands upon existing general guidance on bank funding and borrowings.<sup>2</sup> Where appropriate, examiners should (1) review the provisions of each significant borrowing agreement between the bank and the wholesale institution, (2) determine what assets collateralize

the borrowing (or borrowings), and (3) identify the potential risks presented by the agreement. (See SR-01-8.)

In addition to determining if a bank follows the sound-practice guidance for bank liability management and funding in general, supervisors should take the following steps, as appropriate, when assessing a bank that has material amounts of wholesale borrowings:

- Review the bank's borrowing contracts for embedded options or other features that may affect the bank's liquidity and sensitivity to market risks. In addition, examiners should review the collateral agreements for fees, collateral-maintenance requirements (including triggers for increases in collateral), and other features that may affect the bank's liquidity and earnings.
- Assess the bank's management processes for identifying and monitoring the risks of the various terms of each borrowing contract, including penalties and option features over the expected life of the contract. Examiners should review for evidence that the bank's management, or an independent third party, completed stress tests (1) before the bank entered into the borrowing agreement (or agreements) and (2) periodically thereafter. If the bank relies on independent third-party testing, examiners should verify that management reviewed and accepted the underlying assumptions and test results. In any case, management should not be relying solely on the wholesaler's stress-test results. Also, the stress tests employed should cover a reasonable range of contractual triggers and external events. Such triggers or events include interest-rate changes that may result in the exercise of embedded options or the bank's termination of the agreement, which may entail prepayment penalties. In general, stress-test results should depict the potential impact of these variables on the individual borrowing facility, as well as on the overall earnings and liquidity position of the bank.
- Evaluate management processes for controlling risks, including interest-rate risks arising from the borrowings and liquidity risks. Proper controls include (1) hedges or other plans for minimizing the adverse effects of penalties or interest-rate changes and other triggers for embedded options and (2) contingent funding

1. Wholesale borrowings with embedded options may have variable interest payments or average lives or redemption values that depend on external measures such as reference rates, indexes, or formulas. Embedded options include puttable, callable, convertible, and variable rate advances with caps, floors, collars, step-ups, or amortizing features. In addition, these types of borrowings may contain prepayment penalties.

2. See the supervisory guidance for "Borrowed Funds," section 3010.1; "Asset/Liability Management," section 4020.1; and "Interest-Rate Risk Management," section 4090.1. See also the *Trading and Capital-Markets Activities Manual*, sections 2030.1, "Liquidity Risk," and 3010.1, "Interest-Rate Risk Management." In general, this guidance collectively calls for supervisors to analyze the purpose, effectiveness, concentration exposure, and stability of borrowings and to assess bank management's understanding of liquidity and interest-rate risks associated with borrowing and funding strategies.



plans if borrowings or lines are terminated before the original expected maturity.

- Determine whether the asset/liability management committee or board of directors, as appropriate, is fully informed of the risks and ramifications of complex wholesale-borrowing agreements before engaging in the transactions and on an ongoing basis.
- Determine whether funding strategies for wholesale borrowings, especially those with embedded options, are consistent with both the portfolio objectives of the bank and the level of sophistication of the bank's risk management. Banks without the technical knowledge and whose risk-management systems are insufficient to adequately identify, assess, monitor, and control the risks of com-

plex wholesale borrowings should not be using this funding.

Reliance on wholesale borrowings is consistent with safe and sound banking when management understands the risks of these activities and has systems and procedures in place to properly monitor and control the risks. Supervisors and examiners, however, should take appropriate steps to follow up on institutions that use complex funding instruments without adequately understanding their risks or without proper risk-management systems and controls. Examiners should also seek corrective action when funding mechanisms or strategies are inconsistent with prudent funding needs and objectives.

# Complex Wholesale Borrowings

## Examination Objectives

Effective date May 2001

Section 3012.2

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1. To review the terms of wholesale-borrowing contracts to identify embedded options or other features that may affect the bank's liquidity and sensitivity to market risks.
2. To assess management's technical knowledge, systems, and processes for identifying, assessing, monitoring, and controlling the risks (including liquidity risk and interest-rate risk) associated with wholesale borrowing, and to assess the bank's stress-testing practices and contingency-funding plans.
3. To determine if the bank's board of directors or its asset/liability management committee is fully aware of the risks associated with and ramifications of engaging in complex wholesale-borrowing agreements.
4. To ascertain whether the bank's wholesale-borrowing funding and hedging strategies are consistent with its portfolio objectives and the level of management's sophistication.

# Complex Wholesale Borrowings

## Examination Procedures

Effective date May 2001

## Section 3012.3

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1. Review the bank's borrowing contracts to identify embedded options or other features that may affect the bank's liquidity and sensitivity to market risks. Also review the collateral agreements to determine what fees, collateral-maintenance requirements (including triggers for increases in collateral), and other agreed-upon features may affect the bank's liquidity and earnings.
2. Assess the bank's management processes for identifying and monitoring the risks of the various terms of each borrowing contract, including penalties and option features over the expected life of the contract.
  - a. Obtain and examine evidence to determine whether the bank's management, or an independent third party, completed stress tests before the bank entered into the borrowing agreement (or agreements) and periodically thereafter.
  - b. If the bank relies on independent third-party testing, verify that management reviewed and accepted the underlying assumptions and test results.
3. Evaluate the management processes for controlling risks, including (1) interest-rate risks arising from the borrowings and (2) liquidity risks.
4. Determine if the asset/liability management committee or board of directors, as appropriate, is fully informed of the risks and ramifications of complex wholesale-borrowing agreements both before engaging in the transactions and on an ongoing basis.
5. Determine if funding strategies for wholesale borrowings, especially those with embedded options, are consistent with both the portfolio objectives of the bank and the level of sophistication of the bank's risk management.
6. Seek the corrective action taken by the institution when funding mechanisms or strategies are inconsistent with prudent funding needs and objectives.

# Deferred Compensation Agreements

Effective date May 2005

## Section 3015.1

As part of their executive compensation and retention programs, banks and other financial institutions (collectively referred to in this section as “institutions”) often enter into deferred compensation agreements with selected employees. These agreements are generally structured as nonqualified retirement plans for federal income tax purposes and are based on individual agreements with selected employees.

Institutions often purchase bank-owned life insurance (BOLI) in connection with many of their deferred compensation agreements. (See sections 4042.1 and 2210.1 for an explanation of the accounting for BOLI transactions). BOLI may produce attractive tax-equivalent yields that offset some or all of the costs of the agreements.

Deferred compensation agreements are commonly referred to as *indexed retirement plans* (IRPs) or as *revenue-neutral plans*. The institution’s designated management and accounting staff that is responsible for the institution’s financial reporting must regularly review the accounting for deferred compensation agreements to ensure that the obligations under the agreements are appropriately measured and reported in accordance with generally accepted accounting principles (GAAP). In so doing, the management and accounting staff should apply and follow Accounting Principles Board Opinion No. 12, “Omnibus Opinion—1967,” as amended by Statement of Financial Accounting Standards No. 106 (FAS 106), “Employers’ Accounting for Postretirement Benefits Other Than Pensions” (hereafter referred to as APB 12).

IRPs are one type of deferred compensation agreement that institutions enter into with selected employees. IRPs are typically designed so that the spread each year, if any, between the tax-equivalent earnings on the BOLI covering an individual employee and a hypothetical earnings calculation is deferred and paid to the employee as a post-retirement benefit. This spread is commonly referred to as *excess earnings*. The hypothetical earnings are computed on the basis of a predefined variable index rate (for example, the cost of funds or the federal funds rate) times a notional amount. The notional amount is typically the amount the institution initially invested to purchase the BOLI plus subsequent after-tax benefit payments actually made to the employee. By including the after-

tax benefit payments and the amount initially invested to purchase the BOLI in the notional amount, the hypothetical earnings reflect an estimate of what the institution could have earned if it had not invested in the BOLI or entered into the IRP with the employee. Each employee’s IRP may have a different notional amount on which the index is based. The individual IRP agreements also specify the retirement age and vesting provisions, which can vary from employee to employee.

An IRP agreement typically requires the excess earnings that accrue before an employee’s retirement to be recorded in a separate liability account. Once the employee retires, the balance in the liability account is generally paid to the employee in equal, annual installments over a set number of years (for example, 10 or 15 years). These payments are commonly referred to as the *primary benefit* or *pre-retirement benefit*.

An employee may also receive the excess earnings that are earned after his or her retirement. This benefit may continue until the employee’s death and is commonly referred to as the *secondary benefit* or *post-retirement benefit*. The secondary benefit is paid annually, once the employee has retired, and is in addition to the primary benefit.

Examiners should be aware that some institutions may not be correctly accounting for the obligations under an IRP. Because many institutions were incorrectly accounting for IRPs, the federal banking and thrift agencies issued on February 11, 2004, an Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance. (See SR-04-4.) The guidance is stated here, except for the information on the reporting of deferred compensation agreement obligations in the bank Call Reports and on changes in accounting for those agreements. Examiners should determine whether an institution’s deferred compensation agreements are correctly accounted for. If the accounting is incorrect, assurance should be obtained from the institution’s management that corrections will be made in accordance with GAAP and the advisory’s instructions for changes in accounting. The examiner’s findings should be reported in the examination report. Also report the nature of the accounting errors and the estimated financial impact that correcting the errors will have on the institution’s

financial statements, including its earnings and capital position.

## ACCOUNTING FOR DEFERRED COMPENSATION AGREEMENTS, INCLUDING IRPs

Deferred compensation agreements with select employees under individual contracts generally do not constitute post-retirement income plans (that is, pension plans) or post-retirement health and welfare benefit plans. The accounting for individual contracts that, when taken together, do not represent a post-retirement plan should follow APB 12. If the individual contracts, taken together, are equivalent to a plan, the plan should be accounted for under Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions," or under FAS 106.

APB 12 requires that an employer's obligation under a deferred compensation agreement be accrued according to the terms of the individual contract over the required service period to the date the employee is fully eligible to receive the benefits, or the *full eligibility date*. Depending on the individual contract, the full eligibility date may be the employee's expected retirement date, the date the employee entered into the contract, or a date between these two dates. APB 12 does not prescribe a specific accrual method for the benefits under deferred compensation contracts, stating only that the "cost of those benefits shall be accrued over that period of the employee's service in a systematic and rational manner." The amounts to be accrued each period should result in a deferred compensation liability at the full eligibility date that equals the then-present value of the estimated benefit payments to be made under the individual contract.

APB 12 does not specify how to select the discount rate to measure the present value of the estimated benefit payments. Therefore, other relevant accounting literature must be considered in determining an appropriate discount rate. An institution's incremental borrowing rate<sup>1</sup> and

the current rate of return on high-quality fixed-income debt securities<sup>2</sup> should be the acceptable discount rates to measure deferred compensation agreement obligations. An institution must select and consistently apply a discount-rate policy that conforms with GAAP.

For each IRP, an institution should calculate the present value of the expected future benefit payments under the IRP at the employee's full eligibility date. The expected future benefit payments can be reasonably estimated. They should be based on reasonable and supportable assumptions and should include both the primary benefit and, if the employee is entitled to excess earnings that are earned after retirement, the secondary benefit. The estimated amount of these benefit payments should be discounted because the benefits will be paid in periodic installments after the employee retires. The number of periods the primary and any secondary benefit payments should be discounted may differ because the discount period for each type of benefit payment should be based on the length of time during which each type of benefit will be paid, as specified in the IRP.

After the present value of the expected future benefit payments has been determined, the institution should accrue an amount of compensation expense and a liability each year from the date the employee enters into the IRP until the full eligibility date. The amount of these annual accruals should be sufficient to ensure that a deferred compensation liability equal to the present value of the expected benefit payments is recorded by the full eligibility date. *Any method of deferred compensation accounting that does not recognize some expense for the primary benefit and any secondary benefit in each year from the date the employee enters into the IRP until the full eligibility date is not considered to be systematic and rational.*

Vesting provisions should be reviewed to ensure that the full eligibility date is properly determined because this date is critical to the measurement of the liability estimate. Because APB 12 requires that the present value of the expected benefit payments be recorded by the full eligibility date, institutions also need to consider changes in market interest rates to appropriately measure deferred compensation

1. Accounting Principles Board Opinion No. 21, "Interest on Receivables and Payables," paragraph 13, states in part that "the rate used for valuation purposes will normally be at least equal to the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction."

2. FAS 106, paragraph 186, states that "[t]he objective of selecting assumed discount rates is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the accumulated benefits when due."

liabilities. Therefore, to comply with APB 12, institutions should periodically review both their estimates of the expected future benefits under IRPs and the discount rates used to compute the present value of the expected benefit payments, and revise those estimates and rates, when appropriate.

Deferred compensation agreements, including IRPs, may include noncompete provisions or provisions requiring employees to perform consulting services during post-retirement years. If the value of the noncompete provisions cannot be reasonably and reliably estimated, no value should be assigned to the noncompete provisions in recognizing the deferred compensation liability. Institutions should allocate a portion of the future benefit payments to consulting services to be performed in post-retirement years only if the consulting services are determined to be substantive. Factors to consider in determining whether post-retirement consulting services are substantive include but are not limited to (1) whether the services are required to be performed, (2) whether there is an economic benefit to the institution, and (3) whether the employee forfeits the benefits under the agreement for failure to perform such services.

**APPENDIX—EXAMPLES OF ACCOUNTING FOR DEFERRED COMPENSATION AGREEMENTS**

The following are examples of the full-eligibility-date accounting requirements for a basic deferred compensation agreement. The assumptions used in these examples are for illustrative purposes only. An institution must consider the terms of its specific agreements, the current interest-rate environment, and current mortality tables in determining appropriate assumptions to use in measuring and recognizing the present value of the benefits payable under its deferred compensation agreements.

Institutions that enter into deferred compensation agreements with employees, particularly more-complex agreements (such as IRPs), should consult with their external auditors and their respective Federal Reserve Bank to determine the appropriate accounting for their specific agreements.

**Example 1: Fully Eligible at Agreement Inception**

A company enters into a deferred compensation agreement with a 55-year-old employee who has worked five years for the company. The agreement states that, in exchange for the employee’s past and future services and for his or her service as a consultant for two years after retirement, the company will pay an annual benefit of \$20,000 to the employee, commencing on the first anniversary of the employee’s retirement. The employee is fully eligible for the deferred compensation benefit payments at the inception of the agreement, and the consulting services are not substantive.

Other key facts and assumptions used in determining the benefits payable under the agreement and in determining the liability and expense the company should record in each period are summarized in the following table:

Expected retirement age	60
Number of years to expected retirement age	5
Discount rate (%)	6.75
Expected mortality age based on present age	70

At the employee’s expected retirement date, the present value of a lifetime annuity of \$20,000 that begins on that date is \$142,109 (computed as \$20,000 times 7.10545, the factor for the present value of 10 annual payments at 6.75 percent). At the inception date of the agreement, the present value of that annuity of \$102,514 (computed as \$142,109 times 0.721375, the factor for the present value of a single payment in five years at 6.75 percent) is recognized as compensation expense because the employee is fully eligible for the deferred compensation benefit at that date.

The following table summarizes *one* systematic and rational method of recognizing the expense and liability under the deferred compensation agreement:

	A	B	C	D (B + C)	E	F (E + D - A)
<i>Year</i>	<i>Benefit payment (\$)</i>	<i>Service component (\$)</i>	<i>Interest component (\$)</i>	<i>Compensation expense (\$)</i>	<i>Beginning- of-year liability (\$)</i>	<i>End- of-year liability (\$)</i>
0	–	102,514	–	102,514	–	102,514
1	–	–	6,920	6,920	102,514	109,434
2	–	–	7,387	7,387	109,434	116,821
3	–	–	7,885	7,885	116,821	124,706
4	–	–	8,418	8,418	124,706	133,124
5	–	–	8,985	8,985	133,124	142,109
6	20,000	–	9,593	9,593	142,109	131,702
7	20,000	–	8,890	8,890	131,702	120,592
8	20,000	–	8,140	8,140	120,592	108,732
9	20,000	–	7,339	7,339	108,732	96,071
10	20,000	–	6,485	6,485	96,071	82,556
11	20,000	–	5,572	5,572	82,556	68,128
12	20,000	–	4,599	4,599	68,128	52,727
13	20,000	–	3,559	3,559	52,727	36,286
14	20,000	–	2,449	2,449	36,286	18,735
15	20,000	–	1,265	1,265	18,735	0
Totals	200,000	102,514	97,486	200,000		

The following entry would be made at the inception date of the agreement (the final day of year 0) to record the service component of the compensation expense and related deferred compensation agreement liability:

	<i>Debit</i>	<i>Credit</i>
Compensation expense	\$102,514	
Deferred compensation liability		\$102,514

[To record the column B service component]

In each period after the inception date of the agreement, the company would adjust the deferred compensation liability for the interest component and any benefit payment. In addition, the company would reassess the assumptions used in determining the expected future benefits under the agreement and the discount rate used to compute the present value of the expected benefits in each period after the incep-

tion of the agreement, and revise the assumptions and rate, as appropriate.

Assuming that no changes were necessary to the assumptions used to determine the expected future benefits under the agreement or to the discount rate used to compute the present value of the expected benefits, the following entry would be made in year 1 to record the interest component of the compensation expense:

	<i>Debit</i>	<i>Credit</i>
Compensation expense	\$6,920	
Deferred compensation liability		\$6,920

[To record the column C interest component (computed by multiplying the prior-year column F balance by the discount rate)]

Similar entries (but for different amounts) would be made in year 2 through year 15 to record the interest component of the compensation expense.

The following entry would be made in year 6 to record the payment of the annual benefit:

	<i>Debit</i>	<i>Credit</i>
Deferred compensation liability	\$20,000	
Cash		\$20,000

[To record the column A benefit payment]

Similar entries would be made in year 7 through year 15 to record the payment of the annual benefit.

### Example 2: Fully Eligible at Retirement Date

If the terms of the contract described in example 1 had stated that the employee is only entitled to receive the deferred compensation benefit if the sum of the employee’s age and years of service equals 70 or more at the date of retirement, the employee would be fully eligible for the deferred compensation benefit at age 60, after rendering five more years of service. At the employee’s expected retirement date, the present value of a lifetime annuity of \$20,000 that begins on the first anniversary of that date is \$142,109 (computed as \$20,000 times 7.10545, the factor for the present value of 10 annual payments at 6.75 percent). The company would accrue this amount in a systematic and rational manner over the five-year period from the date it entered into the agreement to the date the employee is fully eligible for the deferred compensation benefit. Under *one* systematic and rational method, the annual service component accrual would be \$24,835 (computed as \$142,109 divided by

5.72213, the factor for the future value of five annual payments at 6.75 percent).

Other key facts and assumptions used in determining the benefits payable under the agreement and in determining the liability and expense the company should record in each period are summarized in the following table:

Expected retirement age	60
Number of years to expected retirement age	5
Discount rate (%)	6.75
Expected mortality age based on present age	70

The following table summarizes *one* systematic and rational method of recognizing the expense and liability under the deferred compensation agreement:



	A	B	C	D (B + C)	E	F (E + D - A)
Year	Benefit payment (\$)	Service component (\$)	Interest component (\$)	Compensation expense (\$)	Beginning- of-year liability (\$)	End- of-year liability (\$)
1	–	24,835	–	24,835	–	24,835
2	–	24,835	1,676	26,511	24,835	51,346
3	–	24,835	3,466	28,301	51,346	79,647
4	–	24,835	5,376	30,211	79,647	109,858
5	–	24,835	7,416	32,251	109,858	142,109
6	20,000	–	9,593	9,593	142,109	131,702
7	20,000	–	8,890	8,890	131,702	120,592
8	20,000	–	8,140	8,140	120,592	108,732
9	20,000	–	7,339	7,339	108,732	96,071
10	20,000	–	6,485	6,485	96,071	82,556
11	20,000	–	5,572	5,572	82,556	68,128
12	20,000	–	4,599	4,599	68,128	52,727
13	20,000	–	3,559	3,559	52,727	36,286
14	20,000	–	2,449	2,449	36,286	18,735
15	20,000	–	1,265	1,265	18,735	0
Totals	200,000	124,175	75,825	200,000		

No entry would be made at the inception date of the agreement. The following entry would be made in year 1 to record the service component of the compensation expense and related deferred compensation agreement liability:

	<i>Debit</i>	<i>Credit</i>
Compensation expense	\$24,835	
Deferred compensation liability		\$24,835

[To record the column B service component]

Similar entries would be made in year 2 through year 5 to record the service component of the compensation expense.

In each subsequent period, until the date the employee is fully eligible for the deferred compensation benefit, the company would adjust the deferred compensation liability for the total expense (the service and interest components). In each period after the full eligibility date, the company would adjust the deferred compensa-

tion liability for the interest component and any benefit payment. In addition, the company would reassess the assumptions used in determining the expected future benefits under the agreement and the discount rate used to compute the present value of the expected benefits in each period after the inception of the agreement, and revise the assumptions and rate, as appropriate.

Assuming no changes were necessary to the assumptions used to determine the expected

future benefits under the agreement or to the discount rate used to compute the present value of the expected benefits, the following entry would be made in year 2 to record the interest component of the compensation expense:

	<i>Debit</i>	<i>Credit</i>
Compensation expense	\$1,676	
Deferred compensation liability		\$1,676

[To record the column C interest component (computed by multiplying the prior-year column F balance by the discount rate)]

Similar entries (but for different amounts) would be made in year 3 through year 15 to record the interest component of the compensation expense.

The following entry would be made in year 6 to record the payment of the annual benefit:

	<i>Debit</i>	<i>Credit</i>
Deferred compensation liability	\$20,000	
Cash		\$20,000

[To record the column A benefit payment]

Similar entries would be made in year 7 through year 15 to record the payment of the annual benefit.

Although both bank directors and bank regulators must look carefully at the quality of bank assets and management and at the ability of the bank to control costs, evaluate risks, and maintain proper liquidity, capital adequacy is the area that triggers the most regulatory action, especially in view of prompt corrective action. The primary function of capital is to support the bank's operations, act as a cushion to absorb unanticipated losses and declines in asset values that could otherwise cause a bank to fail, and provide protection to uninsured depositors and debt holders in the event of liquidation. A bank's solvency promotes public confidence in the bank and the banking system as a whole by providing continued assurance that the bank will continue to honor its obligations and provide banking services. By exposing stockholders to a larger percentage of any potential loss, higher capital levels also reduce the subsidy provided to banks by the federal safety net. Capital regulation is particularly important because deposit insurance and other elements of the federal safety net provide banks with an incentive to increase their leverage beyond what the market—in the absence of depositor protection—would permit. Additionally, higher capital levels can reduce the need for regulatory supervision, thereby lowering costs to the banking industry and the government.

The Federal Reserve uses two ratios to help assess the capital adequacy of state members: the risk-based capital ratio and the tier 1 leverage ratio. State member banks may also be subject to separate capital requirements imposed by state banking supervisors.

### OVERVIEW OF THE RISK-BASED CAPITAL MEASURE FOR STATE MEMBER BANKS

The Federal Reserve's risk-based capital guidelines (the guidelines) focus principally on the credit risk associated with the nature of banks' on- and off-balance-sheet exposures and on the type and quality of banks' capital. The risk-based capital guidelines apply to all state member banks. The information provided in this section should be used in conjunction with the guidelines, which are found in Regulation H (12 CFR 208, appendix A).

The risk-based capital guidelines provide a

definition of capital and a framework for calculating risk-weighted assets by assigning assets and off-balance-sheet items to broad categories of credit risk. A bank's risk-based capital ratio is calculated by dividing its qualifying capital (the numerator of the ratio) by its risk-weighted assets (the denominator). The definition of qualifying capital is outlined below, as are the procedures for calculating risk-weighted assets.

The major objectives of the risk-based capital guidelines are to make regulatory capital requirements more sensitive to differences in credit-risk profiles among banking organizations; to factor off-balance-sheet exposures into the assessment of capital adequacy; to minimize disincentives to holding liquid, low-risk assets; and to achieve greater consistency in the evaluation of the capital adequacy of major banking organizations worldwide.

The guidelines set forth minimum supervisory capital standards that apply to all state member banks on a consolidated basis. Most banks are expected to operate with capital levels above the minimum ratios. Banking organizations that are undertaking significant expansion or that are exposed to high or unusual levels of risk are expected to maintain capital well above the minimum ratios; in such cases, the Federal Reserve may specify a higher minimum requirement. In addition, the risk-based capital ratio is used as a basis for categorizing institutions for purposes of prompt corrective action.<sup>1</sup>

For most institutions, the risk-based capital ratio focuses principally on broad categories of credit risk, although the framework for assigning assets and off-balance-sheet items to risk categories does incorporate elements of transfer risk as well as limited instances of interest-rate and market risk.<sup>2</sup> The framework incorporates risks arising from traditional banking activities as well as risks arising from nontraditional activities. The ratio does not, however, incorporate other factors that can affect an institution's financial condition. These factors include overall interest-rate exposure; liquidity, funding, and market risks; the quality and level of earnings;

1. See section 4133.1, "Prompt Corrective Action."

2. A small number of institutions are required to hold capital to support their exposure to market risk. For more information, see the "Market-Risk Measure" subsection below, SR-09-1, "Application of the Market Risk Rule in BHCs and SMBs," or the Federal Reserve's *Trading and Capital-Markets Activities Manual*, section 2110.1, "Capital Adequacy."

investment, loan portfolio, and other concentrations of credit; certain risks arising from nontraditional activities; the effectiveness of loan and investment policies; and management's overall ability to monitor and control financial and operating risks, including the risks presented by concentrations of credit and nontraditional activities. An overall assessment of capital adequacy must take into account these other factors, including, in particular, the level and severity of problem and classified assets as well as a bank's exposure to declines in the economic value of its capital due to changes in interest rates. For this reason, the final supervisory judgment on a bank's capital adequacy may differ significantly from conclusions that might be drawn solely from the level of its risk-based capital ratio.

## DEFINITION OF CAPITAL

For the purpose of risk-based capital, a bank's total capital consists of two types of components: "core capital elements" (which are included in tier 1 capital) and "supplementary capital elements" (which are included in tier 2 capital). To qualify as an element of tier 1 or tier 2 capital, a capital instrument must be unsecured and may not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

Tier 1 capital is generally defined as the sum of core capital elements. Core capital elements consist of common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign currency translation, net of any treasury stock; less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values. For this purpose, net unrealized holding gains on such equity securities and net unrealized holding gains (losses) on available-for-sale debt securities are not included in common stockholders' equity.

### The Components of Qualifying Capital

*Core capital elements (tier 1 capital).* The tier 1 component of a bank's qualifying capital must represent at least 50 percent of qualifying total

capital and may consist of the following items that are defined as core capital elements:

1. Common stockholders' equity,
2. Qualifying noncumulative perpetual preferred stock (including related surplus), and
2. Minority interest in the equity accounts of consolidated subsidiaries.

Tier 1 capital is generally defined as the sum of core capital elements less any amounts of goodwill, other intangible assets, interest-only strips receivables and nonfinancial equity investments that are required to be deducted.

*Common stockholders' equity.* For purposes of calculating the risk-based capital ratio, common stockholders' equity is limited to common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign currency translation, net of any treasury stock; less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values. For this purpose, net unrealized holding gains on such equity securities and net unrealized holding gains (losses) on available-for-sale debt securities are not included in common stockholders' equity.

*Perpetual preferred stock.* Perpetual preferred stock is defined as preferred stock that does not have a maturity date, that cannot be redeemed at the option of the holder of the instrument, and that has no other provisions that will require future redemption of the issue. Consistent with these provisions, any perpetual preferred stock with a feature permitting redemption at the option of the issuer may qualify as capital only if the redemption is subject to prior approval of the Federal Reserve. In general, preferred stock will qualify for inclusion in capital only if it can absorb losses while the issuer operates as a going concern (a fundamental characteristic of equity capital) *and* only if the issuer has the ability and legal right to defer or eliminate preferred dividends.

The only form of perpetual preferred stock that state member banks may consider as an element of tier 1 capital is noncumulative perpetual preferred. While the guidelines allow for the inclusion of noncumulative perpetual preferred stock in tier 1, it is desirable from a supervisory standpoint that voting common stockholders' equity remain the dominant form

of tier 1 capital. Thus, state member banks should avoid overreliance on preferred stock or non-voting equity elements within tier 1. Tier 1 capital elements represent the highest form of capital, namely, permanent equity.

Tier 2 capital consists of a limited amount of the allowance for loan and lease losses; perpetual preferred stock and related surplus that do not qualify for inclusion in tier 1 capital; certain other hybrid capital instruments; mandatory convertible securities; and limited amounts of term subordinated debt, intermediate-term preferred stock, including related surplus, long-term preferred stock with an original term of 20 years or more, and unrealized holding gains on qualifying equity securities.

Capital investments in unconsolidated banking and finance subsidiaries, and reciprocal holdings of other banking organizations' capital instruments, are deducted from a bank's capital. The sum of tier 1 and tier 2 capital less any deductions makes up total capital, which is the numerator of the total risk-based capital ratio. The maximum amount of tier 2 capital that may be included in a bank's qualifying total capital is limited to 100 percent of tier 1 capital (net of goodwill, other intangible assets, and interest-only strips receivables and nonfinancial equity investments that are required to be deducted).

## RISK-WEIGHTING PROCESS

Each asset and off-balance-sheet item is assigned to one of four broad risk categories based on the perceived credit risk of the obligor or, if relevant, the guarantor or type of collateral. These risk categories are assigned weights of 0 percent, 20 percent, 50 percent, and 100 percent. The majority of items fall into the 100 percent risk-weight category. A brief explanation of the components of each category follows. For more detailed information, see the capital adequacy guidelines.

### Risk Categories

#### *Category 1: Zero Percent*

Category 1 includes cash (domestic and foreign) owned and held in all offices of the bank or in transit, as well as gold bullion held in the bank's own vaults or in another bank's vaults on an allocated basis to the extent it is offset by gold bullion liabilities. The category also includes all

direct claims on (including securities, loans, and leases), and the portions of claims that are directly and unconditionally guaranteed by, the central governments of the Organisation for Economic Co-operation and Development (OECD) countries and U.S. government agencies, as well as all direct local currency claims on, and the portions of local currency claims that are directly and unconditionally guaranteed by, the central governments of non-OECD countries, to the extent that the bank has liabilities booked in that currency. A claim is not considered to be unconditionally guaranteed by a central government if the validity of the guarantee depends on some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. government or its agencies that are actively traded in financial markets, such as Government National Mortgage Association (GNMA) securities, are considered to be unconditionally guaranteed. This zero percent category also includes claims collateralized (1) by cash on deposit in the bank or (2) by securities issued or guaranteed by OECD central governments or (3) by U.S. government agencies for which a positive margin of collateral is maintained on a daily basis, fully taking into account any change in the bank's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim.

#### *Category 2: 20 percent*

Category 2 includes cash items in the process of collection, both foreign and domestic; short-term claims on (including demand deposits), and the portions of short-term claims that are guaranteed by, U.S. depository institutions and foreign banks; and long-term claims on, and the portions of long-term claims that are guaranteed by, U.S. depository institutions and OECD banks. This category also includes the portions of claims that are conditionally guaranteed by OECD central governments and U.S. government agencies, as well as the portions of local currency claims that are conditionally guaranteed by non-OECD central governments, to the extent that the bank has liabilities booked in that currency. In addition, this category includes claims on, and the portions of claims that are guaranteed by, U.S. government-sponsored agencies and claims on, and the portions of claims guaranteed by, the International Bank for

Reconstruction and Development (the World Bank), the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the Nordic Investment Bank, and other multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member. General obligation claims on, or portions of claims guaranteed by the full faith and credit of, states or other political subdivisions of the United States or other countries of the OECD-based group are also assigned to this category. Category 2 also includes the portions of claims (including repurchase transactions) that are (1) collateralized by cash on deposit in the bank or by securities issued or guaranteed by OECD central governments or U.S. government agencies that do not qualify for the zero percent risk-weight category; (2) collateralized by securities issued or guaranteed by U.S. government-sponsored agencies; or (3) collateralized by securities issued by multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member.

This risk category also includes claims on,<sup>3a</sup> or guaranteed by, a qualifying securities firm incorporated in the United States or other countries that are members of the OECD-based group of countries<sup>3b</sup> provided that (1) the qualifying securities firm has a long-term issuer credit rating, or a rating on at least one issue of long-term debt, in one of the three highest investment-grade rating categories from a nationally recognized statistical rating organization or (2) the claim is guaranteed by the firm's

3a. Claims on a qualifying securities firm that are instruments the firm, or its parent company, uses to satisfy its applicable capital requirements are not eligible for this risk weight.

3b. With regard to securities firms incorporated in the United States, qualifying securities firms are those securities firms that are broker-dealers registered with the Securities and Exchange Commission (SEC) and are in compliance with the SEC's net capital rule, 17 CFR 240.15c3-1. With regard to securities firms incorporated in any other country in the OECD-based group of countries, qualifying securities firms are those securities firms that a bank is able to demonstrate are subject to consolidated supervision and regulation (covering their direct and indirect subsidiaries, but not necessarily their parent organizations) comparable to that imposed on banks in OECD countries. Such regulation must include risk-based capital requirements comparable to those applied to banks under the Basel Accord.

parent company and the parent company has such a rating. If ratings are available from more than one rating agency, the lowest rating will be used to determine whether the rating requirement has been met. This category also includes a collateralized claim on a qualifying securities firm in such a country, without regard to satisfaction of the rating standard, provided that the claim arises under a contract that (1) is a reverse-repurchase/repurchase agreement or securities-lending/borrowing transaction executed using standard industry documentation; (2) is collateralized by debt or equity securities that are liquid and readily marketable; (3) is marked to market daily; (4) is subject to a daily margin-maintenance requirement under the standard industry documentation; and (5) can be liquidated, terminated, or accelerated immediately in bankruptcy or a similar proceeding, and the security or collateral agreement will not be stayed or avoided, under applicable law of the relevant jurisdiction.<sup>3c</sup>

### *Category 3: 50 percent*

Category 3 includes loans fully secured by first liens on one- to four-family residential properties (either owner-occupied or rented), or on multifamily residential properties, that meet certain criteria. To be included in category 3, loans must have been made in accordance with prudent underwriting standards, be performing in accordance with their original terms, and not be 90 days or more past due or carried in nonaccrual status. For the purposes of the 50 percent risk category, a loan modified on a permanent or trial basis solely pursuant to the U.S. Department of the Treasury's Home Affordable Mortgage Program will be considered to be performing in accordance with its original terms. The following additional criteria must be applied to a loan secured by a multifamily residential property that is included in this category: (1) all principal and interest payments on the loan must have been made on time for at least the year

3c. For example, a claim is exempt from the automatic stay in bankruptcy in the United States if it arises under a securities contract or a repurchase agreement subject to section 555 or 559 of the Bankruptcy Code, respectively (11 USC 555 or 559); a qualified financial contract under section 11(e)(8) of the Federal Deposit Insurance Act (12 USC 1821(e)(8)); or a netting contract between financial institutions under sections 401–407 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 USC 4401–4407) or the Board's Regulation EE (12 CFR 231).

preceding placement in this category, or, in the case of an existing property owner who is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placement in this category; (2) amortization of the principal and interest must occur over a period of not more than 30 years, and the minimum original maturity for repayment of principal must not be less than seven years; and (3) the annual net operating income (before debt service) generated by the property during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate) or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution. Also included in category 3 are privately issued mortgage-backed securities, provided that (1) the structure of the security meets the criteria described in section III.B.3. of the risk-based measure of the capital guidelines (12 CFR 208, appendix A); (2) if the security is backed by a pool of conventional mortgages on one- to four-family residential or multifamily residential properties, each underlying mortgage meets the criteria described above for eligibility for the 50 percent risk category at the time the pool is originated; (3) if the security is backed by privately issued mortgage-backed securities, each underlying security qualifies for the 50 percent risk category; and (4) if the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due. Privately issued mortgage-backed securities that do not meet these criteria or that do not qualify for a lower risk weight are generally assigned to the 100 percent risk category.

Also assigned to category 3 are revenue (nongeneral obligation) bonds or similar obligations, including loans and leases, that are obligations of states or other political subdivisions of the United States (for example, municipal revenue bonds) or other countries of the OECD-based group, but for which the government entity is committed to repay the debt with revenues from the specific projects financed, rather than from general tax funds. Credit-equivalent amounts of derivative contracts involving standard risk obligors (that is, obligors whose loans or debt securities would be assigned to the 100 percent risk category) are

included in the 50 percent category, unless they are backed by collateral or guarantees that allow them to be placed in a lower risk category.

#### *Category 4: 100 percent*

All assets not included in the categories above are assigned to category 4, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

Category 4 includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk. This category includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstanding that involve standard risk claims; investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock acquired for debts previously contracted; all stripped mortgage-backed securities and similar instruments; and commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans secured by residential property that qualify for a lower risk weight). This category also includes claims representing capital of a qualifying securities firm.

This category also includes industrial-development bonds and similar obligations issued under the auspices of states or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise when that party or enterprise, not the government entity, is obligated to pay the principal and interest. All obligations of states or political subdivisions of countries that do not belong to the OECD-based group are also assigned to category 4. The following assets are assigned a risk weight of 100 percent if they have not been deducted from capital: investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital that are issued by other banking organizations; and any intangibles, including those that may have been grandfathered into capital.



## Application of the Risk Weights

The appropriate aggregate dollar value of the amount in each risk category is multiplied by the risk weight associated with that category. The resulting weighted values for each of the risk categories are added together. The resulting sum is the bank's total risk-weighted assets and is the denominator of the risk-based capital ratio.

## Risk Weighting of Off-Balance-Sheet Items

Off-balance-sheet items are incorporated into the risk-based capital ratio through a two-step process. First, an on-balance-sheet "credit-equivalent amount" is calculated, generally by multiplying the face amount of the item by a credit-conversion factor (except for direct-credit substitutes and recourse obligations). Most off-balance-sheet items are assigned to one of the five credit-conversion factors: 0 percent, 10 percent, 20 percent, 50 percent, or 100 percent. These factors are intended to reflect the risk characteristics of the activity in terms of an on-balance-sheet equivalent. Second, once the credit-equivalent amount of the off-balance-sheet item is calculated, the resultant credit-equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor, the nature of any collateral, or external credit ratings. Briefly, the credit-conversion factors are as follows:

- *Items with a zero percent credit-conversion factor* include unused portions of commitments (with the exception of asset-backed commercial paper (ABCP) liquidity facilities) with an original maturity of one year or less, or which are unconditionally cancelable at any time, provided a separate credit decision is made before each drawing under the facility.
- *Items with a 10 percent credit-conversion factor* include unused portions of eligible ABCP liquidity facilities with an original maturity of one year or less.
- *Items with a 20 percent credit-conversion factor* include short-term, self-liquidating trade-related contingencies that arise from the movement of goods.
- *Items with a 50 percent credit-conversion factor* include transaction-related contingencies, which include bid bonds, performance

bonds, warranties, standby letters of credit related to particular transactions, and performance standby letters of credit, as well as acquisitions of risk participations in performance standby letters of credit. In addition, this credit-conversion factor includes unused portions of commitments, including eligible ABCP liquidity facilities, with an original maturity exceeding one year; revolving-underwriting facilities; note-issuance facilities; and other similar arrangements.

- *Items with a 100 percent credit-conversion factor* include, except as otherwise provided within the risk-based capital guidelines, direct-credit substitutes, recourse obligations, sale and repurchase agreements, *ineligible* ABCP liquidity facilities, and forward agreements, as well as securities lent where the securities lender is at risk of loss.

See the risk-based capital guidelines for more information on the use, treatment, and application of credit-conversions factors for off-balance-sheet items and transactions.

For derivative contracts, the credit-equivalent amount for each contract is determined by multiplying the notional principal amount of the underlying contract by a credit-conversion factor and adding the resulting product (which is an estimate of potential future exposure) to the positive mark-to-market value of the contract (which is the current exposure). A contract with a negative mark-to-market value is treated as having a current exposure of zero. Where appropriate, a bank may offset positive and negative mark-to-market values of derivative contracts entered into with a single counterparty subject to a qualifying, legally enforceable, bilateral netting arrangement.

As a general rule, if the terms of a claim can change, the claim should be assigned to the risk category appropriate to the highest risk option available under the terms of the claim. For example, in a collateralized loan where the borrower has the option to withdraw the collateral before the loan is due, the loan would be treated as an uncollateralized claim for risk-based capital purposes. Similarly, a commitment that can be drawn down in the form of a loan or a standby letter of credit would be treated as a commitment to make a standby letter of credit, the higher risk option available under the terms of the commitment.

When an item may be assigned to more than one category, that item generally is assigned to



the lowest eligible risk category. For example, a mortgage originated by the bank for which a 100 percent Federal Housing Administration guarantee has been obtained would be assigned the 20 percent risk weight that is appropriate to claims conditionally guaranteed by a U.S. government agency, rather than the 100 percent risk weight that is appropriate to high loan-to-value single-family mortgages.

While the primary determinant of the risk category of a particular on-balance-sheet asset or off-balance-sheet credit-equivalent amount is the obligor, collateral or guarantees may be used to a limited extent to assign an item to a lower risk category than would be available to the obligor. The only forms of collateral that are recognized for risk-based capital purposes are cash on deposit in the lending bank;<sup>4</sup> securities issued or guaranteed by the central governments of the OECD-based group of countries,<sup>5</sup> U.S. government agencies, or U.S. government-sponsored agencies; and securities issued by multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member. In order for a claim to be considered collateralized for risk-based capital purposes, the underlying arrangements must provide that the claim will be secured by recognized collateral throughout its term. A commitment may be considered collateralized for risk-based capital purposes to the extent that its terms provide that advances made under the commitment will be secured throughout their term.

The extent to which qualifying securities are recognized as collateral is determined by their current market value. The full amount of a claim

for which a positive margin (that is, greater than 100 percent of the claim) of recognized collateral is maintained daily may qualify for a zero percent risk weight. The full amount of a claim that is 100 percent secured by recognized collateral may be assigned to the 20 percent risk category. For partially secured obligations, the secured portion is assigned a 20 percent risk weight. Any unsecured portion is assigned the risk weight appropriate for the obligor or guarantor, if any. The extent to which an off-balance-sheet item is secured by collateral is determined by the degree to which the collateral covers the face amount of the item before it is converted to a credit-equivalent amount and assigned to a risk category. For derivative contracts, this determination is made in relation to the credit-equivalent amount.

The only guarantees that are recognized for risk-based capital purposes are those provided by central or state and local governments of the OECD-based group of countries, U.S. government agencies, U.S. government-sponsored agencies, multilateral lending institutions or regional development banks in which the United States is a shareholder or contributing member, U.S. depository institutions, and foreign banks. If an obligation is partially guaranteed, the portion that is not fully covered is assigned the risk weight appropriate to the obligor or to any collateral. An obligation that is covered by two types of guarantees having different risk weights is apportioned between the two risk categories appropriate to the guarantors.

## Minimum Risk-Based Capital Ratios

Banks are expected to meet a minimum ratio of capital to risk-weighted assets of 8 percent, with at least 4 percent taking the form of tier 1 capital. Banks that do not meet the minimum risk-based capital ratios, or that are considered to lack sufficient capital to support their activities, are expected to develop and implement capital plans acceptable to the Federal Reserve for achieving adequate levels of capital.<sup>6</sup> Such plans should satisfy the provisions of the guidelines or established arrangements that the Federal Reserve has agreed on with designated

4. There is a limited exception to the rule that cash must be on deposit in the lending bank to be recognized as collateral. A bank participating in a syndicated credit secured by cash on deposit in the lead bank may treat its pro rata share of the credit as collateralized, provided that it has a perfected interest in its pro rata share of the collateral.

5. The OECD-based group of countries comprises all full members of the Organization for Economic Cooperation and Development (OECD), as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the Fund's General Arrangements to Borrow. The OECD's thirty member countries include Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States. Any country that has rescheduled its external sovereign debt within the previous five years is not considered to be part of the OECD-based group of countries for risk-based capital purposes.

6. Under the prompt-corrective-action framework, banks that do not meet the minimum risk-based capital ratio are considered undercapitalized and must file capital-restoration plans that meet certain requirements.

banks. In addition, such banks should avoid any actions, including increased risk taking or unwarranted expansion, that would lower or further erode their capital positions. In these cases, examiners are to review and comment on banks' capital plans and their progress in meeting, and continuing to maintain, the minimum risk-based capital requirements.

The bank's board of directors and senior management should be encouraged to establish capital levels and ratios that are consistent with the bank's overall financial profile. When assessing the bank's capital adequacy, it is appropriate to include comments on risk-based capital in the open section of the examination report. Examiner comments should address the adequacy of the bank's plans and progress toward meeting the relevant target ratios.

## Market-Risk Rule

Institutions are responsible for identifying their trading and other market risks and for implementing a sound risk-management program commensurate with those risks. Such programs should include appropriate quantitative metrics as well as ongoing qualitative analysis performed by competent, independent risk-management staff. At a minimum, institutions should reassess annually and adjust their market-risk management programs, taking into account changing firm strategies, market developments, organizational incentive structures, and evolving risk-management techniques.

In August 1996, the Federal Reserve amended its risk-based capital framework to incorporate a measure for market risk for state member banks. The market-risk rule is found in Regulation H (12 CFR 208), appendix E. Under the market-risk rule, certain institutions with significant exposure to market risk must measure that risk using their internal value-at-risk (VaR) measurement model and, subject to parameters in the market-risk rule, hold sufficient levels of capital to cover the exposure. The market-risk rule applies to any insured state member bank whose trading activity (the gross sum of its trading assets and liabilities) equals (1) 10 percent or more of its total assets or (2) \$1 billion or more. On a case-by-case basis, the Federal Reserve may require an institution that does not meet these criteria to comply with the market-risk rule if deemed necessary for safety-and-soundness reasons. The Federal Reserve may

also exclude an institution that meets the criteria if such exclusion is deemed to be consistent with safe and sound banking practices.

The market-risk rule supplements the risk-based capital rules for credit risk; an institution applying the market-risk rule remains subject to the requirements of the credit-risk rules but must adjust its risk-based capital ratio to reflect market risk. In January 2009, the Board issued SR-09-1, "Application of the Market Risk Rule in Bank Holding Companies and State Member Banks," which reiterated some of the market-risk rule's core requirements, provided guidance on certain technical aspects of the rule, and clarified several issues. SR-09-1 discusses (1) the core requirements of the market-risk rule, (2) the market-risk rule capital computational requirements, and (3) the communication and Federal Reserve requirements in order for a bank to use its VaR models. A bank that is applying the market-risk rule must hold capital to support its exposure to two types of risk: (1) general market risk arising from broad fluctuations in interest rates, equity prices, foreign exchange rates, and commodity prices, including risk associated with all derivative positions, and (2) specific risk arising from changes in the market value of debt and equity positions in the trading account due to factors other than broad market movements, including the credit risk of an instrument's issuer. A bank's covered positions include all trading-account positions as well as all foreign-exchange and commodity positions, whether or not they are in the trading account. Banks that are subject to the market-risk capital rules are precluded from applying those rules to positions held in the bank's trading book that act, in form or in substance, as liquidity facilities supporting asset-backed commercial paper (ABCP). (See the definition of *covered positions* in appendix E, section 2(a).) Any facility held in the trading book whose primary function, in form or in substance, is to provide liquidity to ABCP—even if the facility does not qualify as an eligible ABCP liquidity facility under the rule—will be subject to the banking-book risk-based capital requirements. Specifically, organizations will be required to convert the notional amount of all trading-book positions that provide liquidity to ABCP to credit-equivalent amounts by applying the appropriate banking-book credit-conversion factors. For example, the full notional amount of all eligible ABCP liquidity facilities with an original maturity of one year or less will be subject to a 10 percent conversion factor, as

described previously, regardless of whether the facility is carried in the trading account or the banking book.

## Market Risk Rule Provisions for Securities Lending

On February 6, 2006, the Board approved a revision to Regulation H for its market-risk measure of the capital adequacy guidelines. (See 12 CFR 208, appendix E.) The amendment lessened and aligned the capital requirement of state member banks (those that have adopted the market-risk rule) to the risk involved with certain cash collateral that is posted in connection with securities-borrowing transactions.<sup>6a</sup> It also broadened the scope of counterparties for which favorable capital treatment would be applied. (See 71 *Fed. Reg.* 8932, February 22, 2006.) For a detailed description of the market-risk measure, see the Federal Reserve's *Trading and Capital-Markets Activities Manual*, section 2110.1.

## Advanced Approaches Rule

The Board adopted an advanced capital adequacy framework, effective April 1, 2008, that implements, in the United States, the revised international capital framework (Basel II) developed by the Committee on Banking Supervision (See 12 CFR 208, appendix F or 72 *Fed. Reg.* 69287). The rule provides a risk-based capital framework that permits state member banks (SMBs) to use an internal ratings-based approach to calculate credit-risk capital requirements and advanced measurement approaches (AMA) in order to calculate regulatory operational-risk capital requirements. See also the revisions effective March 29, 2010, at 75 *Fed. Reg.* 4636.<sup>6b</sup>

6a. See the Board staff's August 21, 2007, legal interpretation as to the appropriate risk-based capital risk weight to be applied to certain collateralized loans of cash.

6b. The revisions address the Financial Accounting Standards Board's adoption of Statements of Financial Accounting Standards Nos. 166 (ASC topic 860, "Transfers and Servicing") and 167 (ASC subtopic 810-10, "Consolidation—Overall"). These accounting standards make substantive changes to how banking organizations account for many items, including securitized assets, that had been previously excluded from these organizations' balance sheets.

## AMA Interagency Guidance for Operational Risk

On June 3, 2011, the federal banking agencies (the agencies) issued *Interagency Guidance on the Advanced Measurement Approaches for Operational Risk* to address and clarify implementation issues related to the AMA in applying the agencies' advanced capital adequacy framework. This guidance focuses on the combination and use of the required AMA data elements—(1) internal operational loss event data; (2) external operational loss event data; (3) business environment and internal control factors; and (4) scenario analysis, which is discussed in greater detail. Governance and validation are also discussed since they ensure the integrity of a bank's AMA framework. (See SR-11-8 and its attachment.)

## Establishment of a Risk-Based Capital Floor

Section 171(b)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires the agencies to establish minimum leverage and risk-based capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies,<sup>6c</sup> and nonbank financial companies supervised by the Board. These capital requirements cannot be less than the generally applicable capital requirements that apply to insured depository institutions.<sup>6d</sup>

On June 28, 2011, the agencies published a final rule (effective July 28, 2011) that amended the advanced approaches rules with a permanent floor equal to the minimum risk-based capital requirements under the general risk-based capi-

6c. Section 171 of the Dodd-Frank Act (Pub. L. 111-203, section 171, 124 Stat. 1376, 1435-38 (2010)) defines "depository institution holding company" to mean a bank holding company or a savings and loan holding company (as those terms are defined in section 3 of the Federal Deposit Insurance Act) that is organized in the United States, including any bank or savings and loan holding company that is owned or controlled by a foreign organization, but does not include the foreign organization. (See section 171 of the Dodd-Frank Act, 12 USC 5371.)

6d. The "generally applicable" capital requirements are those established by the federal banking agencies to apply to insured depository institutions, regardless of total asset size or foreign exposure, under the prompt corrective action provisions of the Federal Deposit Insurance Act. See 12 USC 5371(a).

tal rules. (See the Board's press release and 76 *Fed. Reg.* 37620, June 28, 2011.) Banking organizations subject to the advanced approaches rules are required to, each quarter, calculate and compare their minimum tier 1 and total risk-based capital ratios as calculated under the general risk-based capital rules with the same ratios as calculated under the advanced approaches risk-based capital rules. They are to compare the lower of the two tier 1 risk-based capital ratios and the lower of the two total capital ratios to the minimum tier 1 ratio requirement and total capital ratio requirement of the advanced approaches rules to determine whether the minimum capital requirements are met.<sup>6e</sup> The amendment prevents the minimum capital requirements for a banking organization that has adopted the advanced approaches rule from declining below the minimum capital requirements that apply to insured depository institutions.

## Documentation

Banks are expected to have adequate systems in place to compute their risk-based capital ratios. Such systems should be sufficient to document the composition of the ratios to be used for regulatory reporting and other supervisory purposes. Generally, supporting documentation will be expected to establish how banks track and report their capital components and on- and off-balance-sheet items that are assigned preferential risk weights, that is, risk weights less than 100 percent. Where a bank has inadequate documentation to support its assignment of a preferential risk weight to a given item, it may be necessary for examiners to assign an appropriate higher weight to that item. Examiners are expected to verify that banks are correctly reporting the information requested on the Reports of Condition and Income, which are used in computing banks' risk-based capital ratios.

## SUPERVISORY CONSIDERATIONS FOR CALCULATING AND EVALUATING RISK-BASED CAPITAL

Certain requirements and factors should be considered in assessing the risk-based capital ratios and the overall capital adequacy of banks. Analy-

sis of these requirements and factors may have a material impact on the amount of capital banks must hold to appropriately support certain activities for on- and off-balance-sheet items, and this analysis must be used in assessing compliance with the guidelines. The requirements and factors to be considered relate to certain capital elements, capital adjustments, balance-sheet activities, off-balance-sheet activities, and the overall assessment of capital adequacy.

## Federal Reserve Review of a Capital Instrument

If the terms and conditions of a particular instrument cause uncertainty as to how the instrument should be treated for capital purposes, it may be necessary to consult with Federal Reserve staff for a final determination. The Federal Reserve will, on a case-by-case basis, determine whether a capital instrument has characteristics that warrant its inclusion in tier 1 or tier 2 capital, as well as determine any quantitative limit on the amount of an instrument that will be counted as an element of tier 1 or tier 2 capital. In making this determination, the Federal Reserve will consider the similarity of the instrument to instruments explicitly treated in the guidelines, the ability of the instrument to absorb losses while the bank operates as a going concern, the maturity and redemption features of the instrument, and other relevant terms and factors.

## Redemptions of Capital

Redemptions of permanent equity or other capital instruments before their stated maturity could have a significant impact on a bank's overall capital structure. Consequently, a bank considering such a step should consult with the Federal Reserve before redeeming any equity or debt capital instrument (before maturity) if its redemption could have a material effect on the level or composition of the institution's capital base.<sup>7</sup>

7. Consultation would not ordinarily be necessary if an instrument was redeemed with the proceeds of, or replaced by, a like amount of a similar or higher-quality capital instrument and if the organization's capital position is considered fully adequate by the Federal Reserve.

6e. 12 CFR 208, appendix F, section 3.

## Capital Elements

This subsection discusses the characteristics of the principal types of capital elements. It also covers terms and conditions that may disqualify an instrument from inclusion in a particular element of capital.

### *Common Stockholders' Equity*

Common stockholders' equity includes common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign-currency translation, net of any treasury stock. A capital instrument that is not permanent or that has preference with regard to liquidation or the payment of dividends is not deemed to be common stock, regardless of whether it is called common stock. Other preferences may also call into question whether the capital instrument is common stock. Close scrutiny should be paid to the terms of common-stock issues of banks that have issued more than one class of common stock. If preference features are found in one of the classes, that class generally should not be treated as common stock.

From a supervisory standpoint, it is desirable that voting common stockholders' equity remain the dominant form of tier 1 capital. Accordingly, the risk-based capital guidelines state that banks should avoid overreliance on nonvoting equity elements in tier 1 capital. Nonvoting equity elements can arise in connection with common stockholders' equity when a bank has two classes of common stock, one voting and the other nonvoting. Alternatively, one class may have so-called super-voting rights entitling the holder to substantially more votes per share than the other class. In this case, the super-voting shares may have so many votes per share that the voting power of the other shares is effectively overwhelmed.

Banks that have nonvoting, or effectively nonvoting, common equity and tier 1 perpetual preferred stock in excess of their voting common stock are clearly overrelying on nonvoting equity elements in tier 1 capital. In such cases, it may be appropriate to reallocate some of the nonvoting equity elements from tier 1 capital to tier 2 capital.

### *Perpetual Preferred Stock*

The risk-based capital guidelines define perpetual preferred stock as preferred stock that has no maturity date, cannot be redeemed at the option of the holder, and has no other provisions that will require future redemption of the issue. Perpetual preferred stock qualifies for inclusion in capital only if it can absorb losses while the issuer operates as a going concern and only if the issuer has the ability and legal right to defer or eliminate preferred dividends.

Perpetual preferred stock with a feature permitting redemption at the option of the issuer may qualify for tier 1 or unlimited tier 2 capital only if the redemption is subject to prior approval of the Federal Reserve. An issue that is convertible at the option of the issuer into another issue of perpetual preferred stock or a lower form of capital, such as subordinated debt, is considered to be redeemable at the option of the issuer. Accordingly, such a conversion must be subject to prior Federal Reserve approval.

Banks may include perpetual preferred stock in tier 1 capital only if the stock is noncumulative. A noncumulative issue may not permit the accruing or payment of unpaid dividends in any form, including the form of dividends payable in common stock. Perpetual preferred stock that calls for the accumulation and future payment of unpaid dividends is deemed to be cumulative, regardless of whether it is called noncumulative, and it is generally includable in tier 2 capital.

Perpetual preferred stock (including auction-rate preferred) in which the dividend rate is reset periodically based, in whole or in part, on the bank's financial condition or credit standing is excluded from tier 1 capital but may generally be included in tier 2 capital. The obligation under such instruments to pay out higher dividends when a bank's condition deteriorates is inconsistent with the essential precept that capital should provide both strength and loss-absorption capacity to a bank during periods of adversity.

Ordinarily, fixed-rate preferred stock and traditional floating- or adjustable-rate preferred stock—in which the dividend rate adjusts in relation to an independent index based solely on general market interest rates and is in no way tied to the issuer's financial condition—do not raise significant supervisory concerns, especially when the adjustable-rate instrument is accompanied by reasonable spreads and cap rates. Such instruments may generally be



included in tier 1 capital, provided they are noncumulative.

Some preferred-stock issues incorporate certain features that raise serious questions about whether these issues will truly serve as a permanent, or even long-term, source of capital. Such features include so-called exploding-rate mechanisms, or similar mechanisms, in which, after a specified period, the dividend rate automatically increases to a level that could create an incentive for the issuer to redeem the instrument. Perpetual preferred stock with this type of feature could cause the issuing bank to be faced with higher dividend requirements at a future date when the bank may be experiencing financial difficulties; it is generally not includable in tier 1 capital.

Traditional convertible perpetual preferred stock, which the holder can convert into a fixed number of common shares at a preset price, ordinarily does not raise supervisory concerns and generally qualifies as tier 1 capital, provided the stock is noncumulative. However, forms of preferred stock that the holder must or can convert into common stock at the market price prevailing at the time of conversion do raise supervisory concerns. Such preferred stock may be converted into an increasing number of common shares as the bank's condition deteriorates and as the market price of the common stock falls. The potential conversion of such preferred stock into common stock could pose a threat of dilution to the existing common shareholders. The threat of dilution could make the issuer reluctant to sell new common stock, or it could place the issuer under strong market pressure to redeem or repurchase the convertible preferred stock. Such convertible preferred stock should generally be excluded from tier 1 capital.

Perpetual preferred stock issues may include other provisions or pricing mechanisms that would provide significant incentives or pressures for the issuer to redeem the stock for cash, especially at a time when the issuer is in a weakened financial condition. As a general matter, an issue that contains such features would be ineligible for tier 1 treatment.

While no formal limit is placed on the amount of noncumulative perpetual preferred stock that may be included in tier 1 capital, the guidelines state that banks should avoid overreliance on preferred stock and other nonvoting equity elements in tier 1 capital. A bank that includes in tier 1 capital perpetual preferred stock in an amount in excess of its voting common stock is

clearly overrelying on perpetual preferred stock in tier 1 capital. In such cases, it may be appropriate to reallocate the excess amount of perpetual preferred stock from tier 1 capital to tier 2 capital.

### *Forward Equity Transactions*

Banking organizations have engaged in various types of forward transactions involving the repurchase of their common stock. In these transactions, the banking organization enters into an arrangement with a counterparty, usually an investment bank or another commercial bank, under which the counterparty purchases common shares of the banking organization, either in the open market or directly from the institution. The banking organization agrees that it will repurchase those shares at an agreed-on forward price at a later date (typically three years or less from the execution date of the agreement). These transactions are used to "lock in" stock repurchases at price levels that are perceived to be advantageous, and they are a means of managing regulatory capital ratios.

Some banking organizations have treated shares under forward equity arrangements as tier 1 capital. However, because these transactions can impair the permanence of the shares and typically have certain features that are undesirable from a supervisory point of view, shares covered by these arrangements have qualities that are inconsistent with tier 1 capital status. Accordingly, any common stock covered by forward equity transactions entered into after the issuance of SR-01-27 (November 9, 2001), other than those specified for deferred compensation or other employee benefit plans, will be excluded from the tier 1 capital of a state member bank, even if executed under a currently existing master agreement. The amount to be excluded is equal to the common stock, surplus, and retained earnings associated with the shares. This guidance does not apply to shares covered under traditional stock buyback programs that do not involve forward agreements.

### *Minority Interest in Equity Accounts of Consolidated Subsidiaries*

Minority interest in equity accounts of consolidated subsidiaries is included in tier 1 capital because, as a general rule, this interest repre-

sents equity that is freely available to absorb losses in operating subsidiaries whose assets are included in a bank's risk-weighted asset base. While not subject to an explicit sublimit within tier 1, banks are expected to avoid using minority interest as an avenue for introducing into their capital structures elements that might not otherwise qualify as tier 1 capital (such as cumulative or auction-rate perpetual preferred stock) or that would, in effect, result in an excessive reliance on preferred stock within tier 1 capital. If a bank uses minority interest in these ways, supervisory concerns may warrant reallocating some of the bank's minority interest in equity accounts of consolidated subsidiaries from tier 1 to tier 2 capital.

Whenever a bank has included perpetual preferred stock of an operating subsidiary in minority interest, a possibility exists that such capital has been issued in excess of the subsidiary's needs, for the purpose of raising cheaper capital for the bank. Stock issued under these circumstances may, in substance if not in legal form, be secured by the subsidiary's assets. If the subsidiary fails, the outside preferred investors would have a claim on the subsidiary's assets that is senior to the claim that the bank, as a common shareholder, has on those assets. Therefore, as a general matter, issuances in excess of a subsidiary's needs do not qualify for inclusion in capital. The possibility that a secured arrangement exists should be considered if the subsidiary on-lends significant amounts of funds to the parent bank, is unusually well capitalized, has cash flow in excess of its operating needs, holds a significant amount of assets with minimal credit risk (for example, U.S. Treasury securities) that are not consistent with its operations, or has issued preferred stock at a significantly lower rate than the parent could obtain for a direct issue.

Some banks may use a nonoperating subsidiary or special-purpose entity (SPE) to issue perpetual preferred stock to outside investors. Such a subsidiary may be set up offshore so a bank can receive favorable tax treatment for the dividends paid on the stock. In such arrangements, a strong presumption exists that the stock is, in effect, secured by the assets of the subsidiary. It has been agreed internationally that a bank may not include in its tier 1 capital minority interest in the perpetual preferred stock of nonoperating subsidiaries. Furthermore, such minority interest may not be included in tier 2 capital unless a bank can conclusively prove that

the stock is unsecured. Even if the bank's accountants have permitted the bank to account for perpetual preferred stock issued through an SPE as stock of the bank, rather than as minority interest in the equity accounts of a consolidated subsidiary, the stock may not be included in tier 1 capital and most likely is not includable in tier 2 capital.

Banks may also use operating or nonoperating subsidiaries to issue subordinated debt. As with perpetual preferred stock issued through such subsidiaries, a possibility exists that such debt is in effect secured and therefore not includable in capital.

### *Minority Interests in Small Business Investment Companies*

Minority interests in small business investment companies (SBICs), in investment funds that hold nonfinancial equity investments, and in subsidiaries engaged in nonfinancial activities are not included in a bank's tier 1 or total capital base if the bank's interest in the company or fund is held under the legal authorities listed in section II.B.5.b. of the capital guidelines (12 CFR 208, appendix A).

### *Allowance for Loan and Lease Losses*

The allowance for loan and lease losses is a reserve that has been established through a charge against earnings to absorb anticipated, but not yet identified, losses on loans or lease-financing receivables. The allowance excludes allocated transfer-risk reserves and reserves created against identified losses. Neither of these two types of reserves is includable in capital. The amount of the allowance for loan and lease losses that is includable in tier 2 capital is limited to 1.25 percent of risk-weighted assets.

### *Net Unrealized Holding Gains (Losses) on Securities Available for Sale*

The Financial Accounting Standards Board's Statement No. 115 (FAS 115), "Accounting for Certain Investments in Debt and Equity Securities," created a new common stockholders' equity account known as "net unrealized holding gains (losses) on securities available for sale." Although this equity account is consid-

ered to be part of a bank's GAAP equity capital, this account should not be included in a bank's regulatory capital calculations. There are exceptions, however, to this rule. A bank that legally holds equity securities in its available-for-sale portfolio<sup>8</sup> may include up to 45 percent of the

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8. Although banks are generally not allowed to hold equity securities except in lieu of debts previously contracted and certain mutual fund holdings, some banks have grandfathered holdings of equity securities in accordance with provisions of the National Bank Act, passed in the 1930s.



pretax net unrealized holding gains on those securities in tier 2 capital. These equity securities must be valued in accordance with generally accepted accounting principles and have readily determinable fair values. Unrealized holding gains may not be included in tier 2 capital if the Federal Reserve determines that the equity securities were not prudently valued. Moreover, if a bank experiences unrealized holding losses in its available-for-sale equity portfolio, these losses must be deducted from tier 1 capital.

### *Mandatory Convertible Debt Securities*

Mandatory convertible debt securities are essentially subordinated-debt securities that receive special capital treatment because a bank has committed to repay the principal from proceeds obtained through the issuance of equity. Banks may include such securities (net of any stock issued that has been dedicated to their retirement) in the form of equity contract notes or equity commitment notes<sup>9</sup> issued before May 15, 1985, as unlimited elements of tier 2 capital, provided that the criteria set forth in 12 CFR 225, appendix B, are met. Consistent with these criteria, mandatory convertible notes are subject to a maximum maturity of 12 years, and a bank must receive Federal Reserve approval before redeeming (or repurchasing) such securities before maturity. The terms of the securities should note that such approval is required.

If a bank has issued common or perpetual preferred stock and dedicated the proceeds to the retirement or redemption of mandatory convertibles,<sup>10</sup> the portion of mandatory convertibles covered by the dedication no longer carries a commitment to issue equity and is effectively rendered into ordinary subordinated debt. Accordingly, the amount of the stock dedicated is netted from the amount of mandatory convertibles includable as unlimited tier 2 capital. The portion of such securities covered by dedica-

tions should be included in capital as subordinated debt, subject to amortization in the last five years of its life and limited, together with other subordinated debt and intermediate-term preferred stock, to 50 percent of tier 1 capital. For example, a bank has an outstanding equity contract note for \$1 million and issues \$300,000 of common stock, dedicating the proceeds to the retirement of the note. The bank would include the \$300,000 of common stock in its tier 1 capital. The \$700,000 of the equity contract note not covered by the dedication would be treated as an unlimited element of the bank's tier 2 capital. The \$300,000 of the note covered by the dedication would be treated as subordinated debt.

In some cases, the indenture of a mandatory convertible debt issue may require the bank to set up segregated trust funds to hold the proceeds from the sale of equity securities dedicated to pay off the principal of the mandatory convertibles at maturity. The portion of mandatory convertible securities covered by the amount of such segregated trust funds is considered secured and may therefore not be included in capital. The maintenance of such a separate segregated fund for the redemption of mandatory convertibles exceeds the requirements of 12 CFR 225, appendix B. Accordingly, if a bank, with the agreement of the debtholders, seeks regulatory approval to eliminate the fund, the approval normally should be given unless supervisory concerns warrant otherwise.

### *Subordinated Debt and Intermediate-Term Preferred Stock*

To qualify as supplementary capital, subordinated debt and intermediate-term preferred stock must have an original average maturity of at least five years. The average maturity of an obligation whose principal is repayable in scheduled periodic payments (for example, a so-called "serial-redemption issue") is the weighted average of the maturities of all such scheduled repayments. If the holder has the option to require the issuer to redeem, repay, or repurchase the instrument before the original stated maturity, maturity is defined as the earliest possible date on which the holder can put the instrument back to the issuing bank. This date may be much earlier than the instrument's stated maturity date. In the last five years before the

9. Equity contract notes are debt securities that obligate the holder to take common or perpetual preferred stock for repayment of principal. Equity commitment notes are redeemable only with the proceeds from the sale of common or perpetual preferred stock.

10. Such a dedication generally must be made in the quarter in which the new common or perpetual preferred stock is issued. There are no restrictions on the actual use of the proceeds of dedicated stock. For example, stock issued under dividend-reinvestment plans or issued to finance acquisitions may be dedicated to the retirement of mandatory convertible debt securities.

maturity of a limited-life instrument, the outstanding amount includable in tier 2 capital must be discounted by 20 percent a year. The aggregate amount of subordinated debt and intermediate-term preferred stock that may be included in tier 2 capital is limited to 50 percent of tier 1 capital.

Consistent with longstanding Federal Reserve policy, a bank may not repay, redeem, or repurchase a subordinated debt issue without the prior written approval of the Federal Reserve. The terms of the debt indenture should note that such approval is required. The Federal Reserve requires this approval to prevent a deteriorating institution from redeeming capital at a time when it needs to conserve its resources and to ensure that subordinated debtholders in a failing bank are not paid before depositors.

Close scrutiny should be given to terms that permit the holder to accelerate payment of principal upon the occurrence of certain events. The only acceleration clauses acceptable in a subordinated-debt issue included in tier 2 capital are those that are triggered by the issuer's insolvency, that is, the appointment of a receiver. Terms that permit the holder to accelerate payment of principal upon the occurrence of other events jeopardize the subordination of the debt since such terms could permit debtholders in a troubled institution to be paid out before the depositors. In addition, debt whose terms permit holders to accelerate payment of principal upon the occurrence of events other than insolvency does not meet the minimum five-year maturity requirement for debt capital instruments. Holders of such debt have the right to put the debt back to the issuer upon the occurrence of the named events, which could happen on a date well in advance of the debt's stated maturity.

Close scrutiny should also be given to the terms of those debt issues in which an event of default is defined more broadly than insolvency or a failure to pay interest or principal when due. There is a strong possibility that such terms are inconsistent with safe and sound banking practice, so the debt issue should not be included in capital. Concern is heightened where an event of default gives the holder the right to accelerate payment of principal or where other borrowings exist that contain cross-default clauses. Some events of default, such as issuing jumbo certificates of deposit or making additional borrowings in excess of a certain amount, may unduly restrict the day-to-day operations of

the bank. Other events of default, such as change of control of the bank or disposal of a bank subsidiary, may limit the flexibility of management or banking supervisors to work out the problems of a troubled bank. Still other events of default, such as failure to maintain certain capital ratios or rates of return or to limit the amount of nonperforming assets or charge-offs to a certain level, may be intended to allow the debtholder to be made whole before a deteriorating institution becomes truly troubled. Debt issues that include any of these types of events of default are not truly subordinated and should not be included in capital. Likewise, banks should not include debt issues in capital that otherwise contain terms or covenants that could adversely affect the liquidity of the issuer; unduly restrict management's flexibility to run the organization, particularly in times of financial difficulty; or limit the regulator's ability to resolve problem-bank situations.

Debt issues, including mandatory convertible securities, in which interest payments are tied to the financial condition of the borrower should generally not be included in capital. The interest payments may be linked to the financial condition of an institution through various ways, such as (1) an auction-rate mechanism; (2) a preset schedule mandating interest-rate increases, either as the credit rating of the bank declines or over the passage of time;<sup>11</sup> or (3) a term that raises the interest rate if payment is not made in a timely fashion. These debt issues raise concerns because as the financial condition of a bank declines, it faces ever-increasing payments on its credit-sensitive subordinated debt at a time when it most needs to conserve its resources. Thus, credit-sensitive debt does not provide the support expected of a capital instrument to an institution whose financial condition is deteriorating; rather, the credit-sensitive feature can accelerate depletion of the institution's resources and increase the likelihood of default

11. Although payment on debt whose interest rate increases over time may not on the surface appear to be directly linked to the financial condition of the issuing bank, such debt (sometimes referred to as expanding- or exploding-rate debt) has a strong potential to be credit-sensitive in substance. Banks whose financial condition has strengthened are more likely to be able to refinance the debt at a lower rate than that mandated by the preset increase, whereas banks whose condition has deteriorated are less likely to do so. Moreover, just when these latter institutions would be in the most need of conserving capital, they would be under strong pressure to redeem the debt as an alternative to paying higher rates and would therefore accelerate the depletion of their resources.

on the debt. While such terms may be acceptable in perpetual preferred stock qualifying for tier 2 capital, they are not acceptable in a capital debt issue because a bank in a deteriorating financial condition does not have the option available in equity issues of eliminating the higher payments without going into default.

When a bank has included subordinated debt issued by an operating or nonoperating subsidiary in its capital, a possibility exists that the debt is in effect secured, and thus not includable in capital. Further details on arrangements regarding a bank's issuance of capital instruments through subsidiaries are discussed in an earlier subsection, "Minority Interest in Equity Accounts of Consolidated Subsidiaries."

## Capital Adjustments

### *Intangible Assets*

*Goodwill and other intangible assets.* Certain intangible assets are deducted from a bank's capital for the purpose of calculating the risk-based capital ratio.<sup>12</sup> Those assets include goodwill and certain other identifiable assets. These assets are deducted from the sum of the core capital components (tier 1 capital).

The only identifiable intangible assets that are eligible to be included in—that is, not deducted from—a bank's capital are marketable mortgage-servicing assets (MSAs), nonmortgage-servicing assets (NMSAs), and purchased credit-card relationships (PCCRs).<sup>13</sup> The total amount of MSAs and PCCRs that may be included in a bank's capital, in the aggregate, cannot exceed 100 percent of tier 1 capital. The total amount of NMSAs and PCCRs is subject to a separate aggregate sublimit of 25 percent of tier 1 capital. In addition, the total amount of credit-enhancing interest-only strips (I/Os) (both purchased and

retained) that may be included in capital cannot exceed 25 percent of tier 1 capital. Amounts of MSAs, NMSAs, PCCRs, and credit-enhancing I/Os (both retained and purchased) in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from a bank's core capital elements in determining tier 1 capital. However, identifiable intangible assets (other than MSAs and PCCRs) acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes, although they will continue to be deducted for applications purposes.

For purposes of calculating the limitations on MSAs, NMSAs, PCCRs, and credit-enhancing I/Os, tier 1 capital is defined as the sum of core capital elements, net of goodwill and net of all identifiable intangible assets other than MSAs, NMSAs, and PCCRs. This calculation of tier 1 is before the deduction of any disallowed MSAs, any disallowed NMSAs, any disallowed PCCRs, any disallowed credit-enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

Banks may elect to deduct disallowed mortgage servicing assets, disallowed non-mortgage servicing assets, and disallowed credit-enhancing I/Os (both purchased and retained) on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent on future taxable income.

Banks must review the book value of goodwill and other intangible assets at least quarterly and make adjustments to these values as necessary. The fair value of MSAs, NMSAs, and PCCRs must also be determined at least quarterly. This determination of fair value should include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account-attrition rates. Examiners will review both the book value and fair value assigned to these assets, as well as supporting documentation during the examination process. The Federal Reserve may require, on a case-by-case basis, an independent valuation of a bank's intangible assets or credit-enhancing I/Os.

*Value limitation.* The amount of eligible servicing assets and PCCRs that a bank may include in

12. Negative goodwill is a liability and is therefore not taken into account in the risk-based capital framework. Accordingly, a bank may not offset goodwill to reduce the amount of goodwill it must deduct from tier 1 capital.

13. Purchased mortgage-servicing rights (PMSRs) no longer exist under the most recent accounting rules that apply to servicing of assets. Under these rules (Financial Accounting Standards Board statements No. 122, "Accounting for Mortgage Servicing Rights," and No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities"), organizations are required to recognize separate servicing assets (or liabilities) for the contractual obligation to service financial assets that entities have either sold or securitized with servicing retained.

capital is further limited to the lesser of 90 percent of their fair value, or 100 percent of their book value, as adjusted for capital purposes in accordance with the instructions in the commercial bank Consolidated Report of Condition and Income (call report). The amount of I/Os that a bank may include in capital shall be its fair value. If both the application of the limits on MSAs, NMSAs, and PCCRs and the adjustment of the balance-sheet amount for these assets would result in an amount being deducted from capital, the bank would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

Consistent with longstanding Federal Reserve policy, banks experiencing substantial growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets or credit-enhancing I/Os.

An arrangement whereby a bank enters into a licensing or leasing agreement or similar transaction to avoid booking an intangible asset should be subject to particularly close scrutiny. Normally, such arrangements will be dealt with by adjusting the bank's capital calculation appropriately. In making an overall assessment of a bank's capital adequacy for applications purposes, the institution's quality and composition of capital are considered together with its holdings of tangible and intangible assets.

*Credit-enhancing interest-only strips receivables (I/Os).* Credit-enhancing I/Os are on-balance-sheet assets that, in form or substance, represent the contractual right to receive some or all of the interest due on transferred assets. I/Os expose the bank to credit risk directly or indirectly associated with transferred assets that exceeds a pro rata share of the bank's claim on the assets, whether through subordination provisions or other credit-enhancement techniques. Such I/Os, whether purchased or retained and including other similar "spread" assets, may be included in, that is, not deducted from, a bank's capital subject to the fair value and tier 1 limitations. (See sections II.B.1.d. and e. of the capital guidelines (12 CFR 208, appendix A).)

Both purchased and retained credit-enhancing I/Os, on a non-tax-adjusted-basis, are included in the total amount that is used for purposes of determining whether a bank exceeds the tier 1 limitation. In determining whether an I/O or other types of spread assets serve as a

credit enhancement, the Federal Reserve will look to the economic substance of the transaction.

### *Disallowed Deferred Tax Assets*

In response to the Financial Accounting Standards Board's Statement No. 109 (FAS 109), "Accounting for Income Taxes," the Federal Reserve adopted a limit on the amount of certain deferred tax assets that may be included in (that is, not deducted from) tier 1 capital for risk-based and leverage capital purposes. Under the rule, certain deferred tax assets can only be realized if an institution earns taxable income in the future. Those deferred tax assets are limited, for regulatory capital purposes, to the amount that the institution expects to realize within one year of the quarter-end report date (based on its projections of future taxable income for that year) or to 10 percent of tier 1 capital, whichever is less.

The reported amount of deferred tax assets, net of any valuation allowance for deferred tax assets, in excess of the lesser of these two amounts is to be deducted from a bank's core capital elements in determining tier 1 capital. For purposes of calculating the 10 percent limitation, tier 1 capital is defined as the sum of core capital elements, net of goodwill and net of all identifiable intangible assets other than MSAs, NMSAs, and PCCRs, but before the deduction of any disallowed MSAs, any disallowed NMSAs, any disallowed PCCRs, any disallowed credit-enhancing I/Os, any disallowed deferred tax assets, and any nonfinancial equity investments.

To determine the amount of expected deferred tax assets realizable in the next 12 months, a bank should assume that all existing temporary differences fully reverse as of the report date. Projected future taxable income should not include net operating-loss carry-forwards to be used during that year or the amount of existing temporary differences a bank expects to reverse within the year. Such projections should include the estimated effect of tax-planning strategies that the organization expects to implement to realize net operating losses or tax-credit carry-forwards that would otherwise expire during the year. A new 12-month projection does not have to be prepared each quarter. Rather, on interim report dates, the future-taxable-income projections may be used for their current fiscal year,

adjusted for any significant changes that have occurred or are expected to occur.

Deferred tax assets that can be realized from taxes paid in prior carry-back years or from future reversals of temporary differences are generally not limited. For banks that have a parent, however, this amount may *not* exceed the amount the bank could reasonably expect its parent to refund. The disallowed deferred tax assets are subtracted from tier 1 capital and also from risk-weighted assets.

### *Nonfinancial Equity Investments*

In general, a bank must deduct from its core capital elements the sum of the appropriate percentages (as determined below) of the adjusted carrying value of all nonfinancial equity investments held by it or its direct or indirect subsidiaries. An equity investment includes the purchase, acquisition, or retention of any equity instrument (including common stock, preferred stock, partnership interests, interests in limited-liability companies, trust certificates, and warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such as a warrant or call option), and any debt instrument that is convertible into equity.<sup>14</sup> The Federal Reserve may treat any other instrument (including subordinated debt) as an equity investment if, in its judgment, the instrument is the functional equivalent of equity or exposes the state member bank to essentially the same risks as an equity instrument.

A nonfinancial equity investment, subject to the risk-based capital rule (the rule), is an equity investment in a nonfinancial company made under the following authorities:

- the authority to invest in SBICs under section 302(b) of the Small Business Investment Act of 1958 (15 USC 682(b))
- the portfolio investment provisions of Regulation K (12 CFR 211.8(c)(3)), including the authority to make portfolio investments through Edge and agreement corporations

A nonfinancial company is an entity that engages in any activity that has not been determined to be permissible for the bank to conduct directly, or to be financial in nature or incidental to

14. This requirement generally does not apply to investments in nonconvertible senior or subordinated debt.

financial activities under section 4(k) of the Bank Holding Company Act (12 USC 1843(k)). The rule does not apply to investments made in companies that engage solely in banking and financial activities, nor does it apply to investments made by a state bank under the authority in section 24(f) of the Federal Deposit Insurance Act (FDI Act). The higher capital charges also do not apply to equity securities acquired and held by a bank as a bona fide hedge of an equity derivatives transaction it entered into lawfully, or to equity securities that are acquired in satisfaction of a debt previously contracted and that are held and divested in accordance with applicable law. The adjusted carrying value of these investments is not included in determining the total amount of nonfinancial equity investments held by the bank. (See SR-02-4 for a general discussion of the risk-based and leverage capital rule changes.)

The bank must deduct from its core capital elements the sum of the appropriate percentages, as stated in table 1, of the adjusted carrying value of all nonfinancial equity investments held by the bank or its direct or indirect subsidiaries. The amount of the percentage deduction increases as the aggregate amount of nonfinancial equity investments held by the bank increases as a percentage of its tier 1 capital.

The “adjusted carrying value” of investments is the aggregate value at which the investments are carried on the balance sheet of the bank, reduced by (1) any unrealized gains on those investments that are reflected in such carrying value but excluded from the bank’s tier 1 capital and (2) associated deferred tax liabilities. For example, for investments held as available-for-sale (AFS), the adjusted carrying value of the investments would be the aggregate carrying value of the investments (as reflected on the consolidated balance sheet of the bank) *less* any unrealized gains on those investments that are included in other comprehensive income and not reflected in tier 1 capital, and associated deferred tax liabilities.<sup>15</sup> The total adjusted carrying value of any nonfinancial equity investment that is subject to deduction is excluded from the bank’s risk-weighted assets and for purposes of computing the denominator of the bank’s risk-based

15. Unrealized gains on AFS equity investments may be included in supplementary capital to the extent permitted by the capital guidelines. In addition, the unrealized losses on AFS equity investments are deducted from tier 1 capital.

Table 1—Deduction for Nonfinancial Equity Investments

*Aggregate adjusted carrying value of all nonfinancial equity investments held directly or indirectly by the bank (as a percentage of the tier 1 capital of the bank)<sup>1</sup>*

*Deduction from core capital elements (as a percentage of the adjusted carrying value of the investment)*

Less than 15 percent	8 percent
15 percent to 24.99 percent	12 percent
25 percent and above	25 percent

1. For purposes of calculating the adjusted carrying value of nonfinancial equity investments as a percentage of tier 1 capital, tier 1 capital is defined as the sum of core capital elements net of goodwill and net of all identifiable intangible assets other than MSAs, NMSAs, and PCCRs, but before

the deduction for any disallowed MSAs, any disallowed NMSAs, any disallowed PCCRs, any disallowed credit enhancing I/Os (both purchased and retained), any disallowed deferred tax assets, and any nonfinancial equity investments.

capital ratio.<sup>16</sup> The total adjusted carrying value is also deducted from average total consolidated assets when computing the leverage ratio.

The deductions are applied on a marginal basis to the portions of the adjusted carrying value of nonfinancial equity investments that fall within the specified ranges of the parent bank's tier 1 capital. The rule sets forth a “stair-step” approach under which each tier of capital charges applies, on a marginal basis, to the adjusted carrying value of the bank's aggregate nonfinancial equity investment portfolio that falls within the specified ratios of the organization's tier 1 capital. The stair-step approach reflects the fact that the financial risks to a bank from equity investment activities increase as the level of these activities accounts for a larger portion of the bank's capital, earnings, and activities. For example, if the adjusted carrying value of all nonfinancial equity investments held by a bank equals 20 percent of its tier 1 capital, then the amount of the deduction would be 8 percent of the adjusted carrying value of all investments up to 15 percent of the bank's tier 1 capital, and 12 percent of the adjusted carrying value of all investments in excess of 15 percent of the bank's tier 1 capital.

With respect to consolidated SBICs, some equity investments may be in companies that are consolidated for accounting purposes. For investments in a nonfinancial company that is consolidated for accounting purposes under GAAP, the bank's adjusted carrying value of the investment is determined under the equity method of accounting (net of any intangibles associated with the investment that are deducted from the bank's core). Even though the assets of the nonfinancial company are consolidated for accounting purposes, these assets (as well as the credit-equivalent amounts of the company's off-balance-sheet items) should be excluded from the bank's risk-weighted assets for regulatory capital purposes.

The capital adequacy guidelines for state member banks establish *minimum* risk-based capital ratios. Banks are at all times expected to maintain capital commensurate with the level and nature of the risks to which they are exposed. The risk to a bank from nonfinancial equity investments increases with its concentration in such investments, and strong capital levels above the minimum requirements are particularly important when a bank has a high degree of concentration in nonfinancial equity investments (for example, in excess of 50 percent of tier 1 capital).

The Federal Reserve will monitor banks and apply heightened supervision, as appropriate, to equity investment activities, including where the bank has a high degree of concentration in nonfinancial equity investments, to ensure that each bank maintains capital levels that are appropriate in light of its equity investment activities. In addition, the Federal Reserve may

16. For example, if 8 percent of the adjusted carrying value of a nonfinancial equity investment is deducted from tier 1 capital, the entire adjusted carrying value of the investment will be excluded from risk-weighted assets when calculating the denominator for the risk-based capital ratio, and from average total consolidated assets when computing the leverage ratio.



impose capital levels established by the capital adequacy rules, in light of the nature or performance of a particular organization's equity investments or the sufficiency of the organization's policies, procedures, and systems to monitor and control the risks associated with its equity investments.

**SBIC investments.** Investments may be made by banks in or through SBICs under section 4(c)(5) of the BHC Act and section 302(b) of the Small Business Investment Act. No deduction is required for nonfinancial equity investments that are held by a bank (1) through one or more SBICs that are consolidated with the bank or (2) in one or more SBICs that are not consolidated with the bank, to the extent that all such investments, in the aggregate, do not exceed 15 percent of the bank's tier 1 capital. Any nonfinancial equity investment that is held through or in an SBIC and that is not required to be deducted from tier 1 capital will be assigned a 100 percent risk weight and included in the bank's consolidated risk-weighted assets.<sup>17</sup>

To the extent the adjusted carrying value of all nonfinancial equity investments that a bank holds through one or more SBICs that are consolidated with the bank, or in one or more SBICs that are not consolidated with the bank, exceeds, in the aggregate, 15 percent of the bank's tier 1 capital, the appropriate percentage of such amounts (as set forth in table 1) must be deducted from the bank's core capital elements. In addition, the aggregate adjusted carrying value of *all* nonfinancial equity investments held through a consolidated SBIC and in a nonconsolidated SBIC (including any investments for

which no deduction is required) must be included in determining, for purposes of table 1, the total amount of nonfinancial equity investments held by the bank in relation to its tier 1 capital.

**Grandfather provisions.** No deduction is required to be made for the adjusted carrying value of any nonfinancial equity investment (or portion of such an investment) that the bank made before March 13, 2000, or that the bank made on or after this date pursuant to a binding written commitment<sup>18</sup> entered into before March 13, 2000, provided that in either case the bank has continuously held the investment since the relevant investment date.<sup>19</sup> A nonfinancial equity investment made before March 13, 2000, includes any shares or other interests the bank received through a stock split or stock dividend on an investment made before March 13, 2000, provided the bank provides no consideration for the shares or interests received and the transaction does not materially increase the bank's proportional interest in the company. The exercise on or after March 13, 2000, of options or warrants acquired before March 13, 2000, is *not* considered to be an investment made before March 13, 2000, if the bank provides any consideration for the shares or interests received upon exercise of the options or warrants. Any nonfinancial equity investment (or portion thereof) that is not required to be deducted from tier 1 capital must be included in determining the total amount of nonfinancial equity investments held by the bank in relation to its tier 1

18. A "binding written commitment" means a legally binding written agreement that requires the bank to acquire shares or other equity of the company, or make a capital contribution to the company, under terms and conditions set forth in the agreement. Options, warrants, and other agreements that give a bank the right to acquire equity or make an investment, but do not require the bank to take such actions, are not considered a binding written commitment for purposes of this provision.

19. For example, if a bank made an equity investment in 100 shares of a nonfinancial company before March 13, 2000, the adjusted carrying value of that investment would not be subject to a deduction. However, if the bank made any additional equity investment in the company after March 13, 2000, such as by purchasing additional shares of the company (including through the exercise of options or warrants acquired before or after March 13, 2000) or by making a capital contribution to the company, and such investment was not made pursuant to a binding written commitment entered into before March 13, 2000, the adjusted carrying value of the additional investment would be subject to a deduction. In addition, if the bank sold and repurchased, after March 13, 2000, 40 shares of the company, the adjusted carrying value of those 40 shares would be subject to a deduction under this provision.

17. If a bank has an investment in an SBIC that is consolidated for accounting purposes but that is not wholly owned by the bank, the adjusted carrying value of the bank's nonfinancial equity investments through the SBIC is equal to the bank's proportionate share of the adjusted carrying value of the SBIC's equity investments in nonfinancial companies. The remainder of the SBIC's adjusted carrying value (that is, the minority interest holders' proportionate share) is excluded from the risk-weighted assets of the bank. If a bank has an investment in an SBIC that is not consolidated for accounting purposes, and the bank has current information that identifies the percentage of the SBIC's assets that are equity investments in nonfinancial companies, the bank may reduce the adjusted carrying value of its investment in the SBIC proportionately to reflect the percentage of the adjusted carrying value of the SBIC's assets that are not equity investments in nonfinancial companies. If a bank reduces the adjusted carrying value of its investment in a nonconsolidated SBIC to reflect financial investments of the SBIC, the amount of the adjustment will be risk-weighted at 100 percent and included in the bank's risk-weighted assets.

capital for purposes of table 1. In addition, any nonfinancial equity investment (or portion thereof) that is not required to be deducted from tier 1 capital will be assigned a 100 percent risk weight and included in the bank's consolidated risk-weighted assets. The following example illustrates these calculations.

A bank has \$1 million in tier 1 capital and has nonfinancial equity investments with an aggregate adjusted carrying value of \$375,000. Of this amount, \$100,000 represents the adjusted carrying value of investments made before March 13, 2000, and an additional \$175,000 represents the adjusted carrying value of investments made through the bank's wholly owned SBIC. The \$100,000 in investments made before March 13, 2000, and \$150,000 of the bank's SBIC investments would not be subject to the rule's marginal capital charges. These amounts are considered for purposes of determining the marginal charge that applies to the bank's covered investments (including the \$25,000 of non-exempt SBIC investments). In this case, the total amount of the bank's tier 1 capital deduction would be \$31,250. This figure is 25 percent of \$125,000, which is the amount of the bank's total nonfinancial equity portfolio subject to the rule's marginal capital charges. The average tier 1 capital charge on the bank's entire nonfinancial equity portfolio would be 8.33 percent.

### *Investments in Unconsolidated Banking and Finance Subsidiaries and Other Subsidiaries*

Generally, debt and equity capital investments and any other instruments deemed to be capital in unconsolidated banking and finance subsidiaries<sup>20</sup> are to be deducted from the consolidated capital of the parent bank, regardless of whether the investment is made by the parent bank or its direct or indirect subsidiaries.<sup>21</sup> Fifty percent of the investment is to be deducted from tier 1 capital and 50 percent from tier 2 capital. When tier 2 capital is not sufficient to absorb the

portion (50 percent) of the investment allocated to it, the remainder (up to 100 percent) is to be deducted from tier 1 capital.

Advances to banking and finance subsidiaries (that is, loans, extensions of credit, guarantees, commitments, or any other credit exposures) not considered as capital are included in risk-weighted assets at the 100 percent risk weight (unless recognized collateral or guarantees dictate weighting at a lower percentage). However, such advances may be deducted from the parent bank's consolidated capital where examiners find that the risks associated with the advances are similar to the risks associated with capital investments, or if such advances possess risk factors that warrant an adjustment to capital for supervisory purposes. These risk factors could include the absence of collateral support or the clear intention of banks to allow the advances to serve as capital to subsidiaries regardless of form.

Although the Federal Reserve does not automatically deduct investments in other unconsolidated subsidiaries or investments in joint ventures and associated companies,<sup>22</sup> the level and nature of such investments should be closely monitored. Resources invested in these entities support assets that are not consolidated with the rest of the bank and therefore may not be generally available to support additional leverage or absorb losses of affiliated institutions. Close monitoring is also necessary because experience has shown that banks often stand behind the losses of affiliated institutions to protect the reputation of the organization as a whole. In some cases, this support has led to losses that have exceeded the investments in such entities.

Accordingly, for risk-based capital purposes, a bank may be required, on a case-by-case basis, to (1) deduct such investments from total capital; (2) apply an appropriate risk-weighted charge against the bank's pro rata share of the assets of the affiliated entity; (3) consolidate the entity on a line-by-line basis; or (4) operate with a risk-based capital ratio above the minimum. In determining the appropriate capital treatment for such actions, the Federal Reserve will generally take into account whether (1) the bank has significant influence over the financial or

20. A banking and finance subsidiary is generally defined as any company engaged in banking or finance in which the parent organization holds directly or indirectly more than 50 percent of the outstanding voting stock, or any such company which is otherwise controlled or capable of being controlled by the parent organization.

21. An exception to this deduction is to be made for shares acquired in the regular course of securing or collecting a debt previously contracted in good faith.

22. Such entities are defined in the instructions to the call report. Associated companies and joint ventures are generally defined as companies in which the bank owns 20 to 50 percent of the voting stock.



managerial policies or operations of the affiliated entity, (2) the bank is the largest investor in the entity, or (3) other circumstances prevail (such as the existence of significant guarantees from the bank) that appear to closely tie the activities of the affiliated company to the bank.

### *Reciprocal Holdings of Banking Organizations' Capital Instruments*

Reciprocal holdings are intentional cross-holdings resulting from formal or informal arrangements between banking organizations to swap or exchange each other's capital instruments. Such holdings of other banking organizations' capital instruments are to be deducted from the total capital of an organization for the purpose of determining the total risk-based capital ratio. Holdings of other banking organizations' capital instruments taken in satisfaction of debts previously contracted or that constitute stake-out investments that comply with the Federal Reserve's policy statement on nonvoting equity investments (12 CFR 225.143) are not deemed to be intentional cross-holdings and are therefore not deducted from a bank's capital.

### **On-Balance-Sheet Activities**

#### *Claims on, and Guaranteed by, OECD Central Governments*

The risk-based capital guidelines assign a zero percent risk weight to all direct claims (including securities, loans, and leases) on the central governments of the OECD-based group of countries and U.S. government agencies. Generally, the only direct claims banks have on the U.S. government and its agencies take the form of Treasury securities. Zero-coupon, that is, single-payment, Treasury securities trading under the U.S. Treasury's Separately Traded Registered Interest and Principal (STRIP) program are assigned to the zero percent risk category. A security that has been stripped by a private-sector entity, such as a brokerage firm, is considered an obligation of that entity and is accordingly assigned to the 100 percent risk category.

Claims that are directly and unconditionally guaranteed by an OECD-based central govern-

ment or a U.S. government agency are also assigned to the zero percent risk category. Claims that are directly but conditionally guaranteed are assigned to the 20 percent risk category. A claim is considered to be conditionally guaranteed by a central government if the validity of the guarantee depends on some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. government or its agencies that are actively traded in financial markets are considered to be unconditionally guaranteed. These include Government National Mortgage Association (GNMA or Ginnie Mae) and Small Business Administration (SBA) securities.

A limited number of U.S. government agency-guaranteed loans are deemed to be unconditionally guaranteed and can be assigned to the zero percent risk category. These include most loans guaranteed by the Export-Import Bank (Eximbank),<sup>23</sup> loans guaranteed by the U.S. Agency for International Development (AID) under its Housing Guaranty Loan Program, SBA loans subject to a secondary participation guaranty in accordance with SBA form 1086, and Farmers Home Administration (FmHA) loans subject to an assignment guaranty agreement in accordance with FmHA form 449-36.

Apart from the exceptions noted in the preceding paragraph, loans guaranteed by the U.S. government or its agencies are considered to be conditionally guaranteed. The guaranteed portion of such loans is assigned to the 20 percent risk category. These include, but are not limited to, loans guaranteed by the Commodity Credit Corporation (CCC), the Federal Housing Administration (FHA), the Overseas Private Investment Corporation (OPIC), the Department of Veterans Affairs (VA), and, except as indicated above, the FmHA and SBA. Loan guarantees offered by OPIC often guarantee against political risk. However, only that portion of a loan guaranteed by OPIC against commercial or credit risk may receive a preferential 20 percent risk weight. The portion of government trust certificates issued to provide funds for the refinancing of foreign military sales loans made by the Federal Financing Bank or the Defense Security Assistance Agency that are indirectly guaranteed by the U.S. government also qualify for the 20 percent risk weight.

<sup>23</sup> Loans guaranteed under Eximbank's Working Capital Guarantee Program, however, receive a 20 percent risk weight.

Most guaranteed student loans are guaranteed by a state agency or nonprofit organization that does not have the full faith and credit backing of the state. The loans are then indirectly guaranteed or reinsured by the U.S. government's Guaranteed Student Loan Program. Under the program, a minimum percentage of the loan is reinsured, but a higher percentage could be guaranteed if the bank has experienced an overall low default rate on guaranteed student loans. Only the portion of the loan covered by the minimum guarantee under the program may be assigned to the 20 percent risk category; the remainder should be assigned a 100 percent risk weight.

### *Claims on, or Guaranteed by, a U.S. Government–Sponsored Agency*

U.S. government–sponsored agencies are agencies originally established or chartered by the federal government to serve public purposes specified by the U.S. Congress. Such agencies generally carry out functions performed directly by the central government in other countries. The obligations of government-sponsored agencies generally are not explicitly guaranteed by the full faith and credit of the U.S. government. Claims (including securities, loans, and leases) on, or guaranteed by, such agencies are assigned to the 20 percent risk category. U.S. government–sponsored agencies include, but are not limited to, the College Construction Loan Insurance Association, Farm Credit Administration, Federal Agricultural Mortgage Corporation, Federal Home Loan Bank System, Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), Federal National Mortgage Association (FNMA or Fannie Mae), Financing Corporation (FICO), Postal Service, Resolution Funding Corporation (REFCORP), Student Loan Marketing Association (SLMA or Sallie Mae), Smithsonian Institution, and Tennessee Valley Authority (TVA).

### *Loans Secured by First Liens on One- to Four-Family Residential Properties and Multifamily Residential Properties*

Qualifying loans on one- to four-family residential properties, either owner-occupied or rented (as defined in the instructions to the call report), are accorded a 50 percent risk weight under the

guidelines. Also eligible for the 50 percent risk weight are loans to builders with substantial project equity for the construction of one- to four-family residences that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest-money deposits.

In addition, qualifying multifamily residential loans that meet certain criteria may be assigned to the 50 percent risk category. These criteria are as follows: All principal and interest payments must have been made on time for at least one year preceding placement in the 50 percent risk category, amortization of the principal and interest must occur within 30 years, the minimum original maturity for repayment of principal cannot be less than seven years, and annual net operating income (before debt service) generated by the property during the most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate). In the case of cooperative or other not-for-profit housing projects, the property must generate sufficient cash flow to provide comparable protection to the bank.

To ensure that only qualifying residential mortgage loans are assigned to this preferential risk weight, examiners are to review the one- to four-family and multifamily residential real estate loans that are included in the 50 percent risk category. Such loans are not eligible for preferential treatment unless they meet the following criteria: The loans are made subject to prudent underwriting standards, the loans are performing in accordance with their original terms and are not delinquent for 90 days or more or carried on nonaccrual status, and the loan-to-value ratios are conservative.<sup>24</sup> For the purpose of this last criterion, the loan-to-value ratio should be based on the value of the property determined by the most current appraisal or, if appropriate, the most current evaluation. Normally, this would be the appraisal or evaluation performed at the time the loan was originated.<sup>25</sup>

If a bank has assigned a 50 percent risk weight to residential mortgage loans made for

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24. A conservative loan-to-value ratio for loans secured by multifamily residential property must not exceed 80 percent (or 75 percent if the loan is based on a floating interest rate).

25. When both first and junior liens are held by the bank and no intervening liens exist, these transactions are treated as single loans secured by a first lien for the purpose of determining the loan-to-value ratio.

the purpose of speculative real estate development or whose eligibility for such preferential treatment is otherwise questionable, and the amounts of nonqualifying loans are readily identifiable, such loans should be reassigned to the 100 percent risk-weight category. If material evidence exists that a bank has assigned a preferential risk weight to residential mortgage loans of questionable eligibility, but the amount of the inappropriately weighted amount cannot be readily identified, the overall evaluation of the bank's capital adequacy should reflect a higher capital requirement than would otherwise be the case.

### *Accrued Interest*

Banks normally report accrued interest on loans and securities in "Other Assets" on the Call Report. The majority of banks will risk-weight the entire amount of accrued interest at 100 percent. However, for risk-based capital purposes, a bank is permitted to allocate accrued interest among the risk categories associated with the underlying claims, provided the bank has systems in place to carry out such an allocation accurately.

### *Off-Balance-Sheet Activities*

Off-balance-sheet transactions include recourse obligations, direct-credit substitutes, residual interests, and asset- and mortgage-backed securities. The treatments for direct-credit substitutes, assets transferred with recourse, and securities issued in connection with asset securitizations and structured financings are described later in this section. The terms *asset securitizations* or *securitizations*, as used in this subsection, include structured financings, as well as asset-securitization transactions.

### *Assets Sold with Recourse*

For risk-based capital adequacy purposes, a bank must hold capital against assets sold with recourse if the bank retains any risk of loss. To qualify as an asset sale with recourse, a transfer of assets must first qualify as a sale according to the GAAP criteria set forth in paragraph 14 of the Financial Accounting Standards Board's Statement No. 140 (FAS 140), "Accounting for

Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." These criteria are summarized in the definition of "transfers of financial assets" in the glossary to the commercial bank Call Report instructions. If a transfer of assets does not meet these criteria, the assets must remain on the bank's balance sheet and are subject to the standard risk-based capital charge.

If a transfer of assets qualifies as a sale under GAAP but the bank retains any risk of loss or obligation for payment of principal or interest, then the transfer is considered to be a sale with recourse. A more detailed definition of an asset sale with recourse may be found in the definition of "sales of assets for risk-based capital purposes" in the glossary to the commercial bank Call Report instructions. Although the assets are removed from a bank's balance sheet in an asset sale with recourse, the credit-equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guaranties or collateral. This assignment also applies when the contractual terms of the recourse agreement limit the seller's risk to a percentage of the value of the assets sold or to a specific dollar amount.

If, however, the risk retained by the seller is limited to some fixed percentage of any losses that might be incurred and there are no other provisions resulting in the direct or indirect retention of risk by the seller, the maximum amount of possible loss for which the selling bank is at risk (the stated percentage times the amount of assets to which the percentage applies) is subject to risk-based capital requirements. The remaining amount of assets transferred would be treated as a sale that is not subject to the risk-based capital requirements. For example, a seller would treat a sale of \$1 million in assets with a recourse provision that the seller and buyer proportionately share in losses incurred on a 10 percent and 90 percent basis, respectively, and with no other retention of risk by the seller, as a \$100,000 asset sale with recourse and a \$900,000 sale not subject to risk-based capital requirements.

There are several exceptions to the general reporting rule for recourse transactions. The first exception applies to recourse transactions for which the amount of recourse the institution is contractually liable for is less than the capital requirement for the assets transferred under the recourse agreement. For such transactions, a bank must hold capital equal to its maximum contractual recourse obligation. For example,

assume an institution transfers a \$100 pool of commercial loans and retains a recourse obligation of 2 percent. Ordinarily, the bank would be subject to an 8 percent capital charge, or \$8. Because the recourse obligation is only 2 percent, however, the bank would be required to hold capital of \$2 against the recourse exposure. This capital charge may be reduced further by the balance of any associated noncapital GAAP recourse liability account.

A second exception to the general rule applies to the transfer of small-business loans and to the transfer of leases on personal property with recourse. A bank that is considered to be well capitalized according to the Federal Reserve's prompt-corrective-action framework should include in risk-weighted assets only the amount of retained recourse—instead of the entire amount of assets transferred—in connection with a transfer of small-business loans or a transfer of leases on personal property with recourse, provided two conditions are met. First, the transaction must be treated as a sale under GAAP; second, the bank must establish a noncapital reserve that is sufficient to cover the bank's estimated liability under the recourse arrangement. With the Board's approval, this exception may also apply to a bank that is considered to be adequately capitalized under the prompt-corrective-action framework. The total outstanding amount of recourse retained under such transactions may not exceed 15 percent of a bank's total risk-based capital without Board approval.

### *Definitions*

The capital adequacy guidelines provide special treatment for recourse obligations, direct-credit substitutes, residual interests, and asset- and mortgage-backed securities involved in asset-securitization activities. A brief discussion of some of the primary definitions follows.

*Credit derivatives.* Credit derivative means a contract that allows one party (the protection purchaser) to transfer the credit risk of an asset or off-balance-sheet credit exposure to another party (the protection provider). The value of a credit derivative is dependent, at least in part, on the credit performance of a "reference asset."

*Credit-enhancing representations and warranties.* When a bank transfers assets, including

servicing rights, it customarily makes representations and warranties concerning those assets. When a bank purchases loan-servicing rights, it may also assume representations and warranties made by the seller or a prior servicer. These representations and warranties give certain rights to other parties and impose obligations on the seller or servicer of the assets. To the extent a bank's representations and warranties function as credit enhancements to protect asset purchasers or investors from credit risk, they are considered as recourse or direct-credit substitutes.

The Federal Reserve's risk-based capital adequacy rule is consistent with the agencies' long-standing recourse treatment of representations and warranties that effectively guarantee the performance or credit quality of transferred loans. However, banks typically make a number of factual warranties that are unrelated to the ongoing performance or credit quality of transferred assets. These warranties entail operational risk, as opposed to the open-ended credit risk inherent in a financial guaranty, and are not considered recourse or a direct-credit substitute. Warranties that create operational risk include warranties that assets have been underwritten or collateral appraised in conformity with identified standards, as well as warranties that provide for the return of assets in instances of incomplete documentation, fraud, or misrepresentation.

Warranties can impose varying degrees of operational risk. For example, a warranty that asset collateral has not suffered damage from potential hazards entails a risk that is offset to some extent by prudent underwriting practices requiring the borrower to provide hazard insurance to the bank. A warranty that asset collateral is free of environmental hazards may present acceptable operational risk for certain types of properties that have been subject to environmental assessment, depending on the circumstances. The appropriate limits for these operational risks are monitored through supervision of a bank's loan-underwriting, -sale, and -servicing practices. Also, a bank that provides warranties to loan purchasers and investors must include associated operational risks in its risk management of exposures arising from loan-sale or securitization-related activities. Banks should be prepared to demonstrate to examiners that operational risks are effectively managed.

Recourse or direct-credit-substitute treatment is required for warranties providing assurances

about the actual value of asset collateral, including that the market value corresponds to its appraised value or that the appraised value will be realized in the event of foreclosure and sale. Warranties such as these, which make representations about the future value of a loan or related collateral, constitute an enhancement of the loan transferred, and thus are recourse arrangements or direct-credit substitutes. When a seller represents that it “has no knowledge” of circumstances that could cause a loan to be other than investment quality, the representation is not recourse. Banks may limit recourse exposure with warranties that directly address the condition of the asset *at the time of transfer* (that is, creation of an operational warranty) and by monitoring compliance with stated underwriting standards. Alternatively, banks might create warranties with exposure caps that would permit it to take advantage of the low-level-recourse rule.

The definition of credit-enhancing representations and warranties excludes warranties—such as early-default clauses and similar warranties that permit the return of, or premium-refund clauses covering, one- to four-family residential first mortgage loans that qualify for a 50 percent risk weight for a maximum period of 120 days from the date of transfer. These warranties may cover only those loans that were originated within one year of the date of transfer.

A premium-refund clause is a warranty that obligates a seller who has sold a loan at a price in excess of par, that is, at a premium, to refund the premium, either in whole or in part, if the loan defaults or is prepaid within a certain period of time. Premium-refund clauses that cover assets guaranteed, in whole or in part, by the U.S. government, a U.S. government agency, or a government-sponsored enterprise are not included in the definition of credit-enhancing representations and warranties, provided the premium-refund clauses are for a period not to exceed 120 days from the date of transfer. The definition also does not include warranties that permit the return of assets in instances of misrepresentation, fraud, or incomplete documentation.

*Early-default clauses.* Early-default clauses typically give the purchaser of a loan the right to return the loan to the seller if the loan becomes 30 or more days delinquent within a stated period after the transfer, for example, four months after transfer. Once the stated period has

expired, the early-default clause will no longer trigger recourse treatment, provided there are no other provisions that constitute recourse.

*Direct-credit substitutes.* The term *direct-credit substitute* refers to an arrangement in which a bank assumes, in form or in substance, credit risk associated with an on- or off-balance-sheet asset or exposure that was not previously owned by the bank (third-party asset), and the risk assumed by the bank exceeds the pro rata share of its interest in the third-party asset. If the bank has no claim on the third-party asset, then the bank’s assumption of any credit risk on the third-party asset is a direct-credit substitute.

The term direct-credit substitute explicitly includes items such as purchased subordinated interests, agreements to cover credit losses that arise from purchased loan-servicing rights, credit derivatives, and lines of credit that provide credit enhancement. Some purchased subordinated interests, such as credit-enhancing I/O strips, are also residual interests for regulatory capital purposes.

Direct-credit substitutes include, but are not limited to—

- financial standby letters of credit that support financial claims on a third party that exceed a bank’s pro rata share of losses in the financial claim;
- guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims that exceed a bank’s pro rata share in the financial claim;
- purchased subordinated interests or securities that absorb more than their pro rata share of losses from the underlying assets;
- credit derivative contracts under which the bank assumes more than its pro rata share of credit risk on a third-party exposure;
- loans or lines of credit that provide credit enhancement for the financial obligations of an account party;
- purchased loan-servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced (mortgage-servicer cash advances that meet the conditions of section III.B.3.a.x. of the guidelines (12 CFR 208, appendix A) are not direct-credit substitutes);
- clean-up calls on third-party assets (clean-up calls that are 10 percent or less of the original pool balance that are exercisable at the option

- of the bank are not direct-credit substitutes); and
- liquidity facilities that provide liquidity support to ABCP (other than eligible ABCP liquidity facilities).

*Clean-up calls.* A clean-up call is an option that permits a servicer or its affiliate (which may be the originator) to take investors out of their positions in a securitization before all of the transferred loans have been repaid. The servicer accomplishes this by repurchasing the remaining loans in the pool once the pool balance has fallen below some specified level. This option in a securitization raises long-standing agency concerns that a bank may implicitly assume a credit-enhancing position by exercising the option when the credit quality of the securitized loans is deteriorating. An excessively large clean-up call facilitates a securitization servicer's ability to take investors out of a pool to protect them from absorbing credit losses, and thus may indicate that the servicer has retained or assumed the credit risk on the underlying pool of loans.

Generally, clean-up calls (whether or not they are exercised) are treated as recourse and direct-credit substitutes. The purpose of treating large clean-up calls as recourse or direct-credit substitutes is to ensure that a bank is not able to provide credit support to the trust investors by repaying its investment when the credit quality of the pool is deteriorating without holding capital against the exposure. The focus should be on the arrangement itself and not the exercise of the call. Thus, the existence, not the exercise, of a clean-up call that does not meet the requirements of the risk-based capital rule will trigger treatment as a recourse obligation or a direct-credit substitute. A clean-up call can function as a credit enhancement because its existence provides the opportunity for a bank (as servicer or an affiliate of a servicer) to provide credit support to investors by taking an action that is within the contractual terms of the securitization documents.

Because clean-up calls can also serve an administrative function in the operation of a securitization, a limited exemption exists for these options. When an agreement permits a bank that is a servicer or an affiliate of the servicer to elect to purchase loans in a pool, the agreement is not considered a recourse obligation or a direct-credit substitute if the agreement permits the banking organization to purchase the

remaining loans in a pool when the balance of those loans is equal to or less than 10 percent of the original pool balance. This treatment will also apply to clean-up calls written with reference to less than 10 percent of the outstanding principal amount of securities. If, however, an agreement permits the remaining loans to be repurchased when their balance is greater than 10 percent of the original pool balance, the agreement is considered to be a recourse obligation or a direct-credit substitute. The exemption from recourse or direct-credit-substitute treatment for a clean-up call of 10 percent or less recognizes the real market need to be able to call a transaction when the costs of keeping it outstanding are burdensome. However, to minimize the potential for using such a feature as a means of providing support for a troubled portfolio, a bank that exercises a clean-up call should not repurchase any loans in the pool that are 30 days or more past due. Alternatively, the bank should repurchase the loans at the lower of their estimated fair value or their par value plus accrued interest.

Banks that repurchase assets pursuant to a clean-up call may do so based on an aggregate fair value for all repurchased assets. Banks do not have to evaluate each individual loan remaining in the pool at the time a clean-up call is exercised to determine fair value. Rather, the overall repurchase price should reflect the aggregate fair value of the assets being repurchased so that the bank is not overpaying for the assets and, in so doing, providing credit support to the trust investors. Examiners will review the terms and conditions relating to the repurchase arrangements in clean-up calls to ensure that transactions are done at the lower of fair value or par value plus accrued interest. Banks should be able to support their fair-value estimates. If the Federal Reserve concludes that a bank has repurchased assets at a price that exceeds the lower of these two amounts, the clean-up call provisions in its future securitizations may be treated as recourse obligations or direct-credit substitutes. Regardless of the size of the clean-up call, the Federal Reserve will closely scrutinize and take appropriate supervisory action for any transaction in which the bank repurchases deteriorating assets for an amount greater than a reasonable estimate of their fair value.

*Eligible ABCP liquidity facility.* An eligible ABCP liquidity facility is a liquidity facility that supports ABCP, in form or in substance, and is

subject to an asset-quality test at the time of draw that precludes funding against assets that are 90 days or more past due or in default. In addition, if the assets that an eligible ABCP liquidity facility is required to fund against are externally rated assets or exposures at the inception of the facility, the facility can be used to fund only those assets or exposures that are externally rated investment grade at the time of funding. Notwithstanding the eligibility requirements set forth in the two preceding sentences, a liquidity facility will be considered an eligible ABCP liquidity facility if the assets that are funded under the liquidity facility and which do not meet the eligibility requirements are guaranteed, either conditionally or unconditionally, by the U.S. government or its agencies or by the central government of an OECD country.

*Externally rated.* Externally rated is a term which means that an instrument or obligation has received a credit rating from a nationally recognized statistical rating organization.

*Face amount.* The face amount is the notional principal, or face value, amount of an off-balance-sheet item; the amortized cost of an asset not held for trading purposes; and the fair value of a trading asset.

*Financial asset.* A financial asset is cash or other monetary instrument, evidence of debt, evidence of an ownership interest in an entity, or a contract that conveys a right to receive or exchange cash or another financial instrument from another party.

*Financial standby letters of credit.* A financial standby letter of credit means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary—

- to repay money borrowed by, advanced to, or for the account of a second party (the account party), or
- to make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

*Spread accounts that function as credit-enhancing interest-only strips.* A spread account is an on-balance-sheet asset that functions as a credit enhancement and that can represent an interest in expected interest and fee cash flows

derived from assets an organization has sold into a securitization. In those cases, the spread account is considered to be a “credit-enhancing interest-only strip” and is subject to the concentration limit. (See SR-02-16.) However, any portion of a spread account that represents an interest in cash that has already been collected and is held by the trustee is a “residual interest” subject to dollar-for-dollar capital, but is not a credit-enhancing interest-only strip subject to the concentration limit. For example, assume that a bank books a single spread-account asset that is derived from two separate cash-flow streams:

- *A receivable from the securitization trust that represents cash that has already accumulated in the spread account.* In accordance with the securitization documents, the cash will be returned to the bank at some date in the future after having been reduced by amounts used to reimburse investors for credit losses. Based on the date when the cash is expected to be paid out to the bank, the present value of this asset is currently estimated to be \$3.
- *A projection of future cash flows that are expected to accumulate in the spread account.* In accordance with the securitization documents, the cash, to the extent collected, will also be returned to the bank at some date in the future after having been reduced by amounts used to reimburse investors for credit losses. Based on the date when the cash is expected to be paid out to the bank, the present value of this asset is currently estimated to be \$2.

Both components of the above spread account are considered to be residual interests under the current capital standards because both represent on-balance-sheet assets subject to more than their pro rata share of losses on the underlying portfolio of sold assets. However, the \$2 asset that represents the bank’s retained interest in future cash flows exposes the organization to a greater degree of risk because the \$2 asset presents additional uncertainty as to whether it will ever be collected. This additional uncertainty associated with the recognition of future subordinated excess cash flows results in the \$2 asset being treated as a credit-enhancing interest-only strip, a subset of residual interests.

The face amount of all of the bank’s credit-enhancing interest-only strips is first subject to a 25 percent of tier 1 capital concentration limit.

Any portion of this face amount that exceeds 25 percent of tier 1 capital is deducted from tier 1 capital. This limit will affect both a bank's risk-based and leverage capital ratios. The remaining face amount of the bank's credit-enhancing interest-only strips, as well as the face amount of the spread-account receivable for cash already held in the trust, is subject to the dollar-for-dollar capital requirement established for residual interests, which affects only the risk-based capital ratios.

*Credit-enhancing interest-only strips.* A credit-enhancing interest-only (I/O) strip is an on-balance-sheet asset that, in form or substance, (1) represents the contractual right to receive some or all of the interest due on transferred assets and (2) exposes the bank to credit risk that exceeds its pro rata claim on the underlying assets, whether through subordination provisions or other credit-enhancing techniques. Thus, credit-enhancing I/O strips include any balance-sheet asset that represents the contractual right to receive some or all of the remaining interest cash flow generated from assets that have been transferred into a trust (or other special-purpose entity), after taking into account trustee and other administrative expenses, interest payments to investors, servicing fees, reimbursements to investors for losses attributable to the beneficial interests they hold, and reinvestment income and ancillary revenues<sup>26</sup> on the transferred assets. Credit-enhancing I/O strips are generally carried on the balance sheet at the present value of the expected net cash flow that the banking organization reasonably expects to receive in future periods on the assets it has securitized, adjusted for some level of prepayments if relevant to that asset class, and discounted at an appropriate market interest rate. Typically, when assets are transferred in a securitization transaction that is accounted for as a sale under GAAP, the accounting recognition given to the credit-enhancing I/O strip on the seller's balance sheet results in the recording of a gain on the portion of the transferred assets that has been sold. This gain is recognized as income, thus increasing the bank's capital position. The economic substance of a transaction will be used to determine whether a particular interest cash flow functions as a credit-enhancing I/O strip, and the Federal Reserve reserves the right to identify other cash flows or

spread-related assets as credit-enhancing I/O strips on a case-by-case basis. For example, including some principal payments with interest and fee cash flows will not otherwise negate the regulatory capital treatment of that asset as a credit-enhancing I/O strip. Credit-enhancing I/O strips include both purchased and retained interest-only strips that serve in a credit-enhancing capacity, even though purchased I/O strips generally do not result in the creation of capital on the purchaser's balance sheet.

*Loan-servicing arrangements.* The definitions of recourse and direct-credit substitute cover loan-servicing arrangements if the bank, as servicer, is responsible for credit losses associated with the serviced loans. However, cash advances made by residential mortgage servicers to ensure an uninterrupted flow of payments to investors or the timely collection of the mortgage loans are specifically excluded from the definitions of recourse and direct-credit substitute, provided the residential mortgage servicer is entitled to reimbursement for any significant advances and this reimbursement is not subordinate to other claims. To be excluded from recourse and direct-credit-substitute treatment, the bank, as servicer, should make an independent credit assessment of the likelihood of repayment of the servicer advance before advancing funds, and should only make such an advance if prudent lending standards are met. Risk-based capital is assessed only against the amount of the cash advance, and the advance is assigned to the risk-weight category appropriate to the party obligated to reimburse the servicer.

If a residential mortgage servicer is not entitled to full reimbursement, then the maximum possible amount of any nonreimbursed advances on any one loan must be contractually limited to an insignificant amount of the outstanding principal on that loan. Otherwise, the servicer's obligation to make cash advances will not be excluded from the definitions of recourse and direct-credit substitute. Banks that act as servicers should establish policies on servicer advances and use discretion in determining what constitutes an "insignificant" servicer advance. The Federal Reserve will exercise its supervisory authority to apply recourse or direct-credit-substitute treatment to servicer cash advances that expose a bank, acting as servicer, to excessive levels of credit risk.

26. According to FAS 140, ancillary revenues include such revenues as late charges on the transferred assets.

*Liquidity facility.* A liquidity facility refers to a



legally binding commitment to provide liquidity support to ABCP by lending to, or purchasing assets from, any structure, program, or conduit in the event that funds are required to repay maturing ABCP.

*Mortgage-servicer cash advance.* A mortgage-servicer cash advance represents funds that a residential mortgage loan servicer advances to ensure an uninterrupted flow of payments, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the loan.

A mortgage-servicer cash advance is not a recourse obligation or a direct-credit substitute if—

- the servicer is entitled to full reimbursement and this right is not subordinated to other claims on the cash flows from the underlying asset pool; or
- for any one loan, the servicer's obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal balance of that loan.

*Nationally recognized statistical rating organization (NRSRO).* An NRSRO is an entity that is recognized by the Division of Market Regulation of the Securities and Exchange Commission (or any successor division) (the commission) as a nationally recognized statistical rating organization for various purposes, including the commission's uniform net capital requirements for brokers and dealers.

*Recourse.* Recourse means the retention by a bank, in form or in substance, of any credit risk directly or indirectly associated with an asset it has transferred that exceeds a pro rata share of the bank's claim on the asset. If a bank has no claim on a transferred asset, then the retention of any risk of credit loss is recourse. A recourse obligation typically arises when a bank transfers assets and retains an explicit obligation to repurchase the assets or absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. The definition of recourse is consistent with the banking agencies' long-standing use of this term, and incorporates existing agency practices regarding retention of risk in asset sales.

Second-lien positions do not, in most circumstances, constitute recourse for the bank receive-

ing the third-party enhancement. Second mortgages or home equity loans generally will not be considered recourse arrangements unless they actually function as credit enhancements.

Third-party enhancements (for example, insurance protection) purchased by the originator of a securitization for the benefit of investors also do not generally constitute recourse. The purchase of enhancements for a securitization, when the bank is completely removed from any credit risk, will not, in most instances, constitute recourse. However, if the purchase or premium price is paid over time and the size of the payment is a function of the third-party's loss experience on the portfolio, such an arrangement indicates an assumption of credit risk and would be considered recourse.

Recourse may also exist implicitly if a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. The following are examples of recourse arrangements:

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

*Residual interests.* Residual interests are defined as any on-balance-sheet asset (1) that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with GAAP) of financial assets, whether through a securitization or otherwise, and (2) that exposes a bank to credit risk directly or indirectly associated with the transferred assets that exceeds a pro rata share of the bank's claim on the asset, whether through subordination provisions or other credit-enhancement techniques. Residual interests generally do not include interests purchased from a third party, except for credit-enhancing I/O strips. Examples of residual interests (assets) include credit-enhancing I/Os; spread accounts; cash-collateral accounts; retained subordinated interests; accrued but uncollected interest on transferred assets that, when collected, will be available to serve in a credit-enhancing capacity; and similar on-balance-sheet assets that function as a credit enhancement. The functional-based definition reflects the fact that securitization structures vary in the way they use certain assets as credit enhancements. Residual interests therefore include any retained on-balance-sheet asset that functions as a credit enhancement in a securitization, regardless of how a bank refers to the asset in financial or regulatory reports.

In general, the definition of residual interests includes only an on-balance-sheet asset that represents an interest created by a transfer of financial assets treated as a sale under GAAP, in accordance with FAS 140. Interests retained in a securitization or transfer of assets accounted for as a financing under GAAP are generally excluded from the definition of residual interest. In the case of GAAP financings, the transferred assets remain on the transferring bank's balance sheet and are, therefore, directly included in both the leverage and risk-based capital calculations. Further, when a transaction is treated as a financing, no gain is recognized from an accounting standpoint.

Sellers' interests generally do not function as a credit enhancement. Thus, if a seller's interest shares losses on a pro rata basis with investors, such an interest would not be considered a residual interest. However, banks should recognize that sellers' interests that are structured to absorb a disproportionate share of losses will be considered residual interests.

The definition of residual interest also includes overcollateralization and spread accounts because these accounts are susceptible to the potential

future credit losses within the loan pools that they support, and thus are subject to valuation inaccuracies. Spread accounts and overcollateralizations that do not meet the definition of credit-enhancing I/O strips generally do not expose a bank to the same level of risk as credit-enhancing I/O strips, and thus are excluded from the concentration limit.

The capital treatment for a residual interest applies when a bank effectively retains the risk associated with that residual interest, even if the residual is sold. The economic substance of the transaction will be used to determine whether the bank has transferred the risk associated with the residual-interest exposure. Banks that transfer the risk on residual interests, either directly through a sale or indirectly through guarantees or other credit-risk-mitigation techniques, and then reassume this risk in any form will be required to hold risk-based capital as though the residual interest remained on the bank's books. For example, if a bank sells an asset that is an on-balance-sheet credit enhancement to a third party and then writes a credit derivative to cover the credit risk associated with that asset, the selling bank must continue to risk-weight, and hold capital against, that asset as a residual interest as if the asset had not been sold.

*Risk participation.* Risk participation means a participation in which the originating party remains liable to the beneficiary for the full amount of an obligation (for example, a direct-credit substitute) notwithstanding that another party has acquired a participation in that obligation.

*Securitization.* Securitization is the pooling and repackaging by a special-purpose entity of assets or other credit exposures into securities that can be sold to investors. Securitization includes transactions that create stratified credit-risk positions whose performance is dependent on an underlying pool of credit exposures, including loans and commitments.

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

*Structured finance program.* A structured finance program refers to a program where receivable interests and asset-backed securities issued by multiple participants are purchased by a special-purpose entity that repackages those exposures into securities that can be sold to investors. Generally, structured finance programs allocate credit risks between the participants and the credit enhancement provided to the program.

### Recourse Obligations, Direct-Credit Substitutes, Residual Interests, and Asset- and Mortgage-Backed Securities

The risk-based capital treatment for recourse obligations, direct-credit substitutes, and asset- and mortgage-backed securities in connection with asset securitizations and structured financings is described below. The capital treatment described in this subsection applies to the bank's own positions.<sup>27</sup>

For banks that comply with the *market-risk rules*, except for liquidity facilities supporting ABCP (in form or in substance), positions in the trading book that arise from asset securitizations, including recourse obligations, residual interests, and direct-credit substitutes, should be treated according to the market-risk rules. However, these banks remain subject to the 25 percent concentration limit for credit-enhancing I/O strips.

#### *Credit-Equivalent Amount*

The credit-equivalent amount for a recourse obligation or a direct-credit substitute is the full amount of the credit-enhanced assets for which the bank directly or indirectly retains or assumes credit risk, multiplied by a 100 percent conversion factor. This treatment, however, does not apply to externally rated positions, senior positions not externally rated, residual interests, certain internally rated positions, and certain small-business loans and leases on personal property transferred with recourse.

27. The treatment also applies to banks that hold positions in their trading book but that are not otherwise subject to the market-risk rules.

### *Risk-Weight Factor for Off-Balance-Sheet Recourse Obligations and Direct-Credit Substitutes*

To determine the bank's risk-weight factor for off-balance-sheet recourse obligations and direct-credit substitutes, the credit-equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. For a direct-credit substitute that is an on-balance-sheet asset (for example, a purchased subordinated security), a bank must calculate risk-weighted assets using the amount of the direct-credit substitute and the full amount of the assets it supports, that is, all the more senior positions in the structure. Direct-credit substitutes that have been syndicated or in which risk participations have been conveyed or acquired are considered off-balance-sheet items that are converted at a 100 percent conversion factor. (See section III.D.1. of the guidelines (12 CFR 208, appendix A) for more capital-treatment details.)

### Ratings-Based Approach—Externally Rated Positions

Each loss position in an asset-securitization structure functions as a credit enhancement for the more senior loss positions in the structure. A multilevel ratings-based approach is used to assess capital requirements on recourse obligations, residual interests (except credit-enhancing I/O strips), direct-credit substitutes, and senior and subordinated securities in asset securitizations. The approach uses credit ratings from the rating agencies to measure relative exposure to credit risk and determine the associated risk-based capital requirement. Using these credit ratings provides a way to use determinations of credit quality that are relied on by investors and other market participants to differentiate the regulatory capital treatment for loss positions representing different gradations of risk.

Under the ratings-based approach, the capital requirement for a position is computed by multiplying the face amount of the position by the appropriate risk weight, determined in accordance with the following tables.<sup>28</sup> Table 2 maps

28. The rating designations (for example, AAA, BBB, A-1, and P-1) used in the tables are illustrative only and do not indicate any preference for, or endorsement of, any particular rating-agency designation system.

Table 2—Risk-Weight Assignments for Externally Rated Long-Term Positions

<i>Long-term rating category</i>	<i>Rating-designation</i>	
	<i>examples</i>	<i>Risk weight</i>
Highest or second-highest investment grade	AAA, AA	20 percent
Third-highest investment grade	A	50 percent
Lowest investment grade	BBB	100 percent
One category below investment grade	BB	200 percent

Table 3—Risk-Weight Assignments for Externally Rated Short-Term Positions

<i>Short-term rating category</i>	<i>Rating-designation</i>	
	<i>examples</i>	<i>Risk weight</i>
Highest investment grade	A-1, P-1	20 percent
Second-highest investment grade	A-2, P-2	50 percent
Lowest investment grade	A-3, P-3	100 percent

long-term ratings to the appropriate risk weights. Table 3 maps short-term ratings for asset-backed commercial paper to the appropriate risk weights. The Federal Reserve has the authority, however, to override the use of certain ratings or the ratings on certain instruments, either on a case-by-case basis or through broader supervisory policy, if necessary or appropriate to address the risk that an instrument poses to a bank.

The ratings-based approach can be used for certain designated asset-backed securities (including asset-backed commercial paper), recourse obligations, direct-credit substitutes, and residual interests (other than credit-enhancing I/O strips). Credit-enhancing I/O strips have been excluded from the ratings-based approach because of their high risk profile. While the ratings-based approach is available for both traded and untraded positions, the approach applies different requirements to each type of position.

#### *Ratings-Based Qualification for Corporate Bonds or Other Securities*

Corporate bonds or other securities not related in any way to a securitization or structured finance program do not qualify for the ratings-based approach. Only mortgage- and asset-backed securities, recourse obligations, direct-credit substitutes, and residual interests (except credit-

enhancing I/O strips) retained, assumed, or issued in connection with a securitization or structured finance program qualify for the ratings-based approach.

Corporate debt instruments, municipal bonds, and other securities that are not related to a securitization or structured finance program do not meet these definitions, and thus do not qualify for the ratings-based approach.

#### *Traded Positions*

A traded position is only required to be rated by one rating agency. A traded position is defined as a position that is externally rated and is retained, assumed, or issued in connection with an asset securitization, where there is a reasonable expectation that, in the near future, the rating will be relied on by unaffiliated investors to purchase the position or will be relied on by an unaffiliated third party to enter into a transaction involving the position, such as a purchase, loan, or repurchase agreement.

For a traded position that has received an external rating on a long-term position that is one grade below investment grade or better, or that has received a short-term rating that is investment grade, the bank multiplies the face amount of the position by the appropriate risk weight, determined in accordance with tables 2 and 3. Stripped mortgage-backed securities and

other similar instruments, such as interest-only or principal-only strips that are not credit enhancements, must be assigned to the 100 percent risk category. If a traded position has received more than one external rating, the lowest single rating will apply. Moreover, if a rating changes, the bank must use the new rating.

Table 3, for short-term ratings, is not identical to table 2, for long-term ratings, because the rating agencies do not assign short-term ratings using the same methodology as they use for long-term ratings. Each short-term rating category covers a range of longer-term rating categories.<sup>29</sup> For example, a P-1 rating could map to a long-term rating that is as high as Aaa or as low as A3.

### *Externally Rated, Nontraded Positions*

For a rated, but untraded, position to be eligible for the ratings-based approach, it must meet certain conditions. To qualify, the position (1) must be rated by more than one rating agency; (2) must have received an external rating on a long-term position that is one grade below investment grade or better or, for a short-term position, a rating that is investment grade or better by all rating agencies providing a rating; (3) must have ratings that are publicly available; and (4) must have ratings that are based on the same criteria used to rate traded securities. If the ratings are different, the lowest single rating will determine the risk-weight category to which the position will be assigned. This treatment does not apply to a credit-enhancing I/O strip.

### *Split or Partially Rated Instruments*

For instruments that have been assigned separate ratings for principal and interest (split or partially rated instruments), the Federal Reserve will apply to the entire instrument the risk weight that corresponds to the lowest component rating. For example, a purchased subordinated security whose principal component is rated BBB, but whose interest component is rated B, is subject to the gross-up treatment accorded to direct-credit substitutes rated B or

lower. Similarly, if a portion of an instrument is unrated, the entire position will be treated as if it was unrated. In addition to this regulatory capital treatment, the Federal Reserve may also, as appropriate, adversely classify and require write-downs for an other-than-temporary impairment on unrated and below-investment-grade securities, including split or partially rated securities. (See SR-02-16.)

### *Senior Positions Not Externally Rated*

A position that is not externally rated (an unrated position), but that is senior or preferred in all respects (including collateralization and maturity) to a rated position that is traded, is treated as if it had the rating assigned to the rated position. The bank must satisfy the Federal Reserve that such treatment is appropriate. Senior unrated positions qualify for the risk weighting of the subordinated rated positions in the same securitization transaction as long as the subordinated rated position (1) is traded and (2) remains outstanding for the entire life of the unrated position, thus providing full credit support until the unrated position matures.

Recourse obligations and direct-credit substitutes (other than residual interests) that do not qualify for the ratings-based approach (or for the internal-ratings, program-ratings, or computer-program-ratings approaches outlined below) receive “gross-up” treatment, that is, the bank holding the position must hold capital against the amount of the position, plus all more senior positions, subject to the low-level-exposure requirement.<sup>30</sup> This grossed-up amount is placed into a risk-weight category according to the obligor or, if relevant, according to the guarantor or nature of the collateral. The grossed-up amount multiplied by both the risk weight and 8 percent is never greater than the full capital charge that would otherwise be imposed on the

30. Gross-up treatment means that a position is combined with all more senior positions in the transaction. The result is then risk-weighted based on the obligor or, if relevant, the guarantor or the nature of the collateral. For example, if a bank retains a first-loss position (other than a residual interest) in a pool of mortgage loans that qualify for a 50 percent risk weight, the bank would include the full amount of the assets in the pool, risk-weighted at 50 percent, in its risk-weighted assets for purposes of determining its risk-based capital ratio. The low-level-exposure rule provides that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which a bank is contractually liable.

29. See, for example, *Moody's Global Ratings Guide*, June 2001, p.3.

assets if they were on the banking organization's balance sheet.<sup>31</sup>

## Residual Interests

### *Credit-Enhancing I/O Strips*

After applying the concentration limit to credit-enhancing I/O strips (both purchased and retained), a bank must maintain risk-based capital for a credit-enhancing I/O strip (both purchased and retained), regardless of the external rating on that position, equal to the remaining amount of the credit-enhancing I/O strip (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred credit-enhancing I/O strip will be treated as if the credit-enhancing I/O strip was retained by the bank and not transferred.

### *Other Residual Interests*

Residual interests that are not eligible for the ratings-based approach receive dollar-for-dollar treatment. Dollar-for-dollar treatment means, effectively, that one dollar in total risk-based capital must be held against every dollar of a residual interest retained on the balance sheet (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. This capital treatment applies to all residual interests, except for credit-enhancing I/O strips that have already been deducted from tier 1 capital under the concentration limit.<sup>32</sup>

Transactions that, in substance, result in the retention of credit risk associated with a transferred residual interest will be treated as if the residual interest was retained by the bank and not transferred.

When the aggregate capital requirement for residual interests and other recourse obligations in connection with the same transfer of assets exceeds the full risk-based capital requirement for those assets, a bank must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest or the full risk-based capital requirement for the assets transferred.

## Accrued Interest Receivables Held on Credit Card Securitizations

In a typical credit card securitization, an institution transfers a pool of credit card receivables to a trust, as well as the rights to receive future payments of principal, interest, and fee income from those receivables. If a securitization transaction qualifies as a sale under FAS 140, the selling institution removes the receivables that were sold from its reported assets and continues to carry any retained interests in the transferred receivables on its balance sheet; the right to these future cash flows should be reported as an accrued interest receivable (AIR) asset.<sup>33,34</sup> Any accrued amounts (cash flows) the institution collects (for example, accrued fees and finance charges) generally must be transferred to the trust and will be used first by the trustee for the benefit of third-party investors to satisfy more senior obligations and for the payment of trust expenses (such as servicing fees, investor-certificate interest, and investor-principal charge-offs). Any remaining excess fee and finance charges will flow back to the seller.

Because the AIR asset constitutes a subordinated residual (retained) interest in the trans-

31. For assets that are assigned to the 100 percent risk-weight category, the minimum capital charge is 8 percent of the amount of assets transferred, and banking organizations are required to hold 8 cents of capital for every dollar of assets transferred with recourse. For assets that are assigned to the 50 percent risk-weight category, the minimum capital charge is 4 cents of capital for every dollar of assets transferred with recourse.

32. Residual interests that are retained or purchased credit-enhancing I/O strips are first subject to a capital concentration limit of 25 percent of tier 1 capital. For risk-based capital purposes (but not for leverage capital purposes), once this concentration limit is applied, a banking organization must then hold dollar-for-dollar capital against the face amount of credit-enhancing I/O strips remaining.

33. The AIR represents fees and finance charges that have been accrued on receivables that the institution has securitized and sold to other investors. For example, in credit card securitizations, this accrued interest receivable asset may include both finance charges billed but not yet collected and finance charges accrued but not yet billed on the securitized receivables.

34. Some institutions may categorize part or all of this receivable as a loan, a "due from trust" account, a retained interest in the trust, or as part of an interest-only strip receivable.

ferred securitized assets, it meets the definition of recourse exposure for risk-based capital purposes. Recourse exposures (such as the AIR asset) require risk-based capital against the full, risk-weighted amount of the assets transferred with recourse, subject to the low-level-recourse rule.<sup>35</sup> The AIR asset serves as a credit enhancement to protect third-party investors in the securitization from credit losses, and it meets the definition of a residual interest under the risk-based capital adequacy rules for the treatment of recourse arrangements. Under those rules, an institution must hold dollar-for-dollar capital against residual interests, even if that amount exceeds the full equivalent risk-based capital charge on the transferred assets.<sup>36</sup> The institution is expected to hold risk-based capital in an amount consistent with the subordinated nature of the AIR asset.

In accounting for the sale, the AIR asset is treated as a subordinated retained interest of credit card receivables when computing the gain or loss on sale. Consistent with GAAP, this means that the value of the AIR, at the date of transfer, must be adjusted based on its relative fair (market) value. This adjustment will typically result in the carrying amount of the AIR being lower than its book (face) value prior to securitization. The AIR should be reported in regulatory reports as “Other Assets” and not as a loan receivable. (See SR-02-12 and SR-02-22).

## Other Unrated Positions

A position (but not a residual interest) maintained in connection with a securitization and that is not rated by a rating agency may be risk-weighted based on the bank’s internal determination of the credit rating of the position, as specified in table 4, multiplied by the face amount of the position. The bank may use three approaches to determine the capital requirements for certain unrated direct-credit substitutes and recourse obligations. Under each of

these approaches, the bank must satisfy the Federal Reserve that the use of the approach is appropriate for the particular bank and for the exposure being evaluated. The risk weight that may be applied to an exposure under these alternative approaches is limited to a minimum of 100 percent.

### *Internal Risk-Rating Systems for Asset-Backed Commercial Paper Programs*

A bank that has a qualifying internal risk-rating system can use that system to apply the ratings-based approach to its unrated direct-credit substitutes in asset-backed commercial paper programs. Internal risk ratings could be used to qualify such a credit enhancement for a risk weight of 100 percent or 200 percent under the ratings-based approach, but not for a risk weight of less than 100 percent.

Most sophisticated banking organizations that participate extensively in the asset-securitization business assign internal risk ratings to their credit exposures, regardless of the form of the exposure. Usually, internal risk ratings more finely differentiate the credit quality of a banking organization’s exposures than the categories the banking agencies use to evaluate credit risk during bank examinations (pass, substandard, doubtful, or loss). An individual bank’s internal risk ratings may be associated with a certain probability of default, loss in the event of default, and loss volatility.

The credit enhancements that sponsors obtain for their commercial paper conduits are rarely rated or traded. If an internal risk-ratings approach were not available for these unrated credit enhancements, the provider of the enhancement would have to obtain two ratings solely to avoid the gross-up treatment that would otherwise apply to nontraded positions in asset securitizations for risk-based capital purposes. However, before a provider of an enhancement decides whether to provide a credit enhancement for a particular transaction (and at what price), the provider will generally perform its own analysis of the transaction to evaluate the amount of risk associated with the enhancement. An internal risk-ratings approach, therefore, is potentially less costly than a ratings-based approach that relies exclusively on ratings by the rating agencies for the risk weighting of these positions.

35. The low-level-recourse rule limits the maximum risk-based capital requirement to the lesser of a banking organization’s maximum contractual exposure or the full capital charge against the outstanding amount of assets transferred with recourse.

36. For a complete description of the appropriate capital treatment for recourse, residual interests, and credit-enhancing interest-only strips, see “Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations,” 66 *Fed. Reg.* 59614 (November 29, 2001).

Table 4—Risk-Weight Assignments for Unrated Positions Using the Alternative Approaches<sup>1</sup>

<i>Rating category</i>	<i>Rating-designation examples</i>	<i>Risk weight</i>
Highest or second-highest investment grade	AAA, AA	100 percent
Third-highest investment grade	A	100 percent
Lowest investment grade	BBB	100 percent
One category below investment grade	BB	200 percent

1. such as the internal ratings approach

Internal risk ratings that correspond to the rating categories of the rating agencies can be mapped to risk weights under the Federal Reserve's capital standards. This mapping can be done in a way that would make it possible to differentiate the riskiness of various unrated direct-credit substitutes in asset-backed commercial paper programs based on credit risk. The use of internal risk ratings, however, may raise concerns about the accuracy and consistency of the ratings, especially because the mapping of ratings to risk-weight categories will give banks an incentive to rate their risk exposures in a way that minimizes the effective capital requirement. A bank engaged in asset-backed commercial paper securitization activities that wishes to use the internal risk-ratings approach must therefore be able to demonstrate to the satisfaction of the Federal Reserve, before relying on its internal ratings, that the bank's internal credit-risk rating system is adequate. Adequate internal risk-rating systems usually have the following characteristics:

- The internal risk ratings are an integral part of an effective risk-management system that explicitly incorporates the full range of risks arising from the bank's participation in securitization activities. The system must also fully take into account the effect of such activities on the bank's risk profile and capital adequacy.
- The ratings link to measurable outcomes, such as the probability that a position will experience any losses, the expected losses on that position in the event of default, and the degree of variance in losses given default on that position.
- The ratings separately consider the risk associated with the underlying loans and borrow-

ers, as well as the risk associated with the specific positions in a securitization transaction.

- The ratings identify gradations of risk among "pass" assets, and not just among assets that have deteriorated to the point that they fall into "watch" grades. Although it is not necessary for a bank to use the same categories as the rating agencies, its internal ratings must correspond to the ratings of the rating agencies so that the Federal Reserve can determine which internal risk rating corresponds to each rating category of the rating agencies. A bank would be responsible for demonstrating, to the satisfaction of the Federal Reserve, how these ratings correspond with the rating-agency standards that are used as the framework for the asset-securitization portion of the risk-based capital rule. This correlation is necessary so that the mapping of credit ratings to risk-weight categories in the ratings-based approach can be applied to internal ratings.
- The ratings classify assets into each risk grade using clear, explicit criteria, even for subjective factors.
- Independent credit-risk-management or loan-review personnel assign or review the credit-risk ratings. These personnel should have adequate training and experience to ensure that they are fully qualified to perform this function.
- An internal audit procedure periodically verifies that internal risk ratings are assigned in accordance with the bank's established criteria.<sup>37</sup>

37. The audit may be performed by any group within the organization that is qualified to audit the system and is independent of both the group that makes the decision to extend credit to the asset-backed commercial paper program and the groups that develop and maintain the internal credit-risk rating system. (See SR-02-16.)



- The performance of internal ratings is tracked over time to evaluate how well risk grades are being assigned, make adjustments to the rating system when the performance of the rated positions diverges from assigned ratings, and adjust individual ratings accordingly.
- Credit-risk rating assumptions are consistent with, or more conservative than, the credit-risk rating assumptions and methodologies of the rating agencies.

If it determines that a bank's rating system is not adequate, the Federal Reserve may preclude the bank from applying the internal risk-ratings approach to new transactions for risk-based capital purposes until the deficiencies have been remedied. Additionally, depending on the severity of the problems identified, the Federal Reserve may decline to rely on the internal risk ratings that the bank had applied to previous transactions for purposes of determining its regulatory capital requirements.

#### *Ratings of Specific Unrated Positions in Structured Financing Programs*

A bank may also use a rating obtained from a rating agency for an unrated direct-credit substitute or recourse obligation (other than a residual interest) that is assumed or retained in connection with a structured finance program, if a rating agency has reviewed the terms of the program (according to the specifications set by the rating agency) and stated a rating for positions associated with the program. If the program has options for different combinations of assets, standards, internal credit enhancements, and other relevant factors, and if the rating agency specifies ranges of rating categories to them, the bank may apply the rating category that corresponds to the bank's position. To rely on a program rating, the bank must demonstrate to the Federal Reserve's satisfaction that the credit-risk rating assigned to the program meets the same standards generally used by rating agencies for rating traded positions.

The bank must also demonstrate to the Federal Reserve's satisfaction that the criteria underlying the rating agency's assignment of ratings for the structured financing program are satisfied for the particular position. If a bank participates in a securitization sponsored by another party, the Federal Reserve may authorize the bank to use this approach based on a programmatic

rating obtained by the sponsor of the program.

Banks with limited involvement in securitization activities may find the above alternative to be useful. In addition, some banks extensively involved in securitization activities already rely on ratings of the credit-risk positions under their securitization programs as part of their risk-management practices. Such banks can rely on these ratings for regulatory capital purposes if the ratings are part of a sound overall risk-management process and the ratings reflect the risk of nontraded positions to the banks.

This approach in a structured financing program can be used to qualify a direct-credit substitute or recourse obligation (but not a residual interest) for a risk weight of 100 percent or 200 percent of the face value of the position under the ratings-based approach, but not for a risk weight of less than 100 percent.

#### *Credit-Assessment Computer Programs*

A bank (particularly a bank with limited involvement in securitization activities) may use an internal ratings-based approach if it is using an acceptable credit-assessment computer program, developed by a rating agency, to determine the rating of a direct-credit substitute or a recourse obligation (but not a residual interest) issued in connection with a structured finance program. To be used by a bank for risk-based capital purposes, a computer program must have been developed by a rating agency. Further, the bank must demonstrate to the satisfaction of the Federal Reserve that the computer program's credit assessments correspond credibly and reliably to the rating standards of the rating agencies for traded positions in securitizations and with the rating of traded positions in the financial markets. The latter would generally be shown if investors and other market participants significantly used the computer program for risk-assessment purposes. In addition, the bank must demonstrate to the Federal Reserve's satisfaction that the program was designed to apply to its particular direct-credit substitute or recourse exposure and that it has properly implemented the computer program. In general, sophisticated banks with extensive securitization activities should use this approach only if the computer program is an integral part of their risk-management systems and if the bank's systems fully capture the risks from its securitization activities. This computer-program approach can

be used to qualify a direct-credit substitute or recourse obligation (but not a residual interest) for a risk weight of 100 percent or 200 percent of the face value of the position under the ratings-based approach, but not for a risk weight of less than 100 percent.

## Limitations on Risk-Based Capital Requirements

### *Low-Level Exposure*

If a bank's maximum contractual exposure to loss retained or assumed in connection with a recourse obligation or a direct-credit substitute, except for a residual interest, is less than the effective risk-based capital requirement for the enhanced assets, the risk-based capital requirement is limited to the maximum contractual exposure, less any recourse liability account established in accordance with GAAP. This limitation does not apply when a bank provides credit enhancement beyond any contractual obligation to support assets it has sold.

### *Mortgage-Related Securities or Participation Certificates Retained in a Mortgage Loan Swap*

If a bank holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support the recourse obligation plus the percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of capital required for the on-balance-sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the bank continued to hold the loans as on-balance-sheet assets.

### *Related On-Balance-Sheet Assets*

If a recourse obligation or a direct-credit substitute also appears as a balance-sheet asset, the balance-sheet asset is not included in a bank's risk-weighted assets to the extent the value of the balance-sheet asset is already included in the off-balance-sheet credit-equivalent amount for the recourse obligation or direct-credit substitute. In the case of loan-servicing assets and

similar arrangements with embedded recourse obligations or direct-credit substitutes, both the on-balance-sheet assets and the related recourse obligations and direct-credit substitutes must be separately risk-weighted and incorporated into the risk-based capital calculation.

### *Asset-Backed Commercial Paper Program Assets and Related Minority Interests*

An asset-backed commercial paper (ABCP) program typically is a program through which a bank provides funding to its corporate customers by sponsoring and administering a bankruptcy-remote special-purpose entity that purchases asset pools from, or extends loans to, those customers.<sup>38</sup> The asset pools in an ABCP program might include, for example, trade receivables, consumer loans, or asset-backed securities. The ABCP program raises cash to provide funding to the bank's customers, primarily (that is, more than 50 percent of the ABCP's issued liabilities) through the issuance of externally rated commercial paper into the market. Typically, the sponsoring bank provides liquidity and credit enhancements to the ABCP program. These enhancements aid the program in obtaining high credit ratings that facilitate the issuance of the commercial paper.<sup>39</sup>

Under the Board's risk-based capital rule, a bank that qualifies as a primary beneficiary and must consolidate an ABCP program that is defined as a variable interest entity under GAAP may not exclude the consolidated ABCP program's assets from risk-weighted assets when it consolidates ABCP program assets. The bank must assess the appropriate risk-based capital charge against any exposures of the bank arising in connection with such ABCP programs, including direct-credit substitutes, recourse obligations, residual interests, liquidity facilities, and loans, in accordance with sections III.B.5., III.C., and III.D. of the risk-based capital rule (12 CFR

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

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

208, appendix A). A bank sponsoring a program issuing ABCP that does not meet the rule's definition of an ABCP program must include the program's assets in the institution's risk-weighted asset base.

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

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

Short-term commitments with an original maturity of one year or less expose banks to a lower degree of credit risk than longer-term commitments. This difference in the degree of credit risk is reflected in the risk-based capital requirement for the different types of exposure. The Board's capital guidelines impose a 10 percent credit-conversion factor on eligible short-term liquidity facilities supporting ABCP. A 50 percent credit-conversion factor applies to eligible long-term ABCP liquidity facilities. These credit-conversion factors apply regardless of whether the structure issuing the ABCP meets the rule's definition of an ABCP program. For example, a capital charge would apply to an eligible short-term liquidity facility that provides liquidity support to ABCP where the ABCP constitutes less than 50 percent of the securities issued by the program, thus causing the issuing structure not to meet the rule's definition of an ABCP program. However, if a bank (1) does not meet this definition and must include the program's assets in its risk-weighted asset base or (2) otherwise chooses to include the program's assets in risk-weighted assets, then no risk-based capital requirement will be assessed against any liquidity facilities provided by the bank that support the program's ABCP. Ineligible liquidity facilities will be treated as

recourse obligations or direct-credit substitutes for the purposes of the Board's risk-based capital guidelines.

The resulting credit-equivalent amount would then be risk-weighted according to the underlying assets or the obligor, after considering any collateral or guarantees, or external credit ratings, if applicable. For example, if an eligible short-term liquidity facility providing liquidity support to ABCP covered an asset-backed security (ABS) externally rated AAA, then the notional amount of the liquidity facility would be converted at 10 percent to an on-balance-sheet credit-equivalent amount and assigned to the 20 percent risk-weight category appropriate for AAA-rated ABS.<sup>40</sup>

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

For example, assume a bank provides a program-wide credit enhancement that would absorb 10 percent of the losses in all of the underlying asset pools in an ABCP program and pool-specific liquidity facilities that cover 100 percent of each of the underlying asset pools. The bank would be required to hold capital against 10 percent of the underlying asset pools because it is providing the program-wide credit enhancement. The bank would also be required to hold capital against 90 percent of the liquidity facilities it is providing to each of the underlying asset pools.

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

<sup>40</sup> See section 4030.1 and also the Board staff's October 12, 2007, legal interpretation regarding the risk-based capital treatment of ABCP liquidity facilities.

tions have overlapping exposures to the same ABCP program.

*Asset-quality test.* For a liquidity facility, either short- or long-term, that supports ABCP *not* to be considered a recourse obligation or a direct-credit substitute, it must meet the rule's definition of an *eligible ABCP liquidity facility*. An eligible ABCP liquidity facility must meet a reasonable asset-quality test that, among other things, precludes funding assets that are 90 days or more past due or in default. When assets are 90 days or more past due, they typically have deteriorated to the point where there is an extremely high probability of default. Assets that are 90 days past due, for example, often must be placed on nonaccrual status in accordance with the agencies' Uniform Retail Credit Classification and Account Management Policy.<sup>41</sup> Further, they generally must also be classified substandard under that policy.

The rule's asset-quality test specifically allows a bank to reflect certain guarantees providing credit protection to the bank providing the liquidity facility. In particular, the "days-past-due limitation" is not applied with respect to assets that are either conditionally or unconditionally guaranteed by the U.S. government or its agencies or by another OECD central government. To qualify as an eligible ABCP liquidity facility, if the assets covered by the liquidity facility are initially externally rated (at the time the facility is provided), the facility can be used to fund only those assets that are externally rated investment grade at the time of funding.

The practice of purchasing assets that are externally rated below investment grade out of an ABCP program is considered the equivalent of providing credit protection to the commercial paper investors. Thus, liquidity facilities permitting purchases of below-investment-grade securities will be considered either recourse obligations or direct-credit substitutes. However, the "investment-grade" limitation is not applied in the asset-quality test with respect to assets that are conditionally or unconditionally guaranteed by the U.S. government or its agencies or by another OECD central government. If the asset-quality tests are not met (that is, if a bank actually funds through the liquidity facility assets that do not satisfy the facility's asset-quality tests), the liquidity facility will be considered a

recourse obligation or a direct-credit substitute and generally will be converted at 100 percent.

## Risk-Based Capital Treatment of Certain Off-Balance-Sheet Items and Certain Other Types of Transactions

### *Distinction Between Financial and Performance Standby Letters of Credit*

For risk-based capital purposes, the vast majority of standby letters of credit a bank issues are considered financial in nature. On the one hand, in issuing a financial standby letter of credit, a bank guarantees that the account party will fulfill a contractual financial obligation that involves payment of money. On the other hand, in issuing a performance standby letter of credit, a bank guarantees that the account party will fulfill a contractual nonfinancial obligation, that is, an obligation that does not entail the payment of money. For example, a standby letter of credit that guarantees that an insurance company will pay as required under the terms of a policy is deemed to be financial and is converted at 100 percent, while a letter of credit that guarantees a contractor will pave a street according to certain specifications is deemed to be performance related and is converted at 50 percent. Financial standby letters of credit have a higher conversion factor in large part because, unlike performance standby letters of credit, they tend to be drawn down only when the account party's financial condition has deteriorated.

### *Participations of Off-Balance-Sheet Transactions*

If a standby letter of credit or commitment has been participated to other institutions in the form of a syndication, as defined in the instructions to the Call Report, that is, if each bank is

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

responsible only for its pro rata share of loss and there is no recourse to the originating bank, each bank includes only its pro rata share of the standby or commitment in its risk-based capital calculation.

The treatment differs, however, if the participation takes the form of a conveyance of a risk participation. In such a participation, the originating bank remains liable to the beneficiary for the full amount of the standby or commitment if the institution that has acquired the participation fails to pay when the instrument is drawn. Under this arrangement, the originating bank is exposed to the credit risk of the institution that has acquired the conveyance rather than that of the account party. Accordingly, for risk-based capital purposes, the originating bank should convert the full amount of the standby or commitment to an on-balance-sheet credit-equivalent amount. The credit-equivalent amount of the portion of the credit that has not been conveyed is assigned to the risk category appropriate to the obligor, after giving effect to any collateral or guarantees. The portion that has been conveyed is assigned either to the same risk category as the obligor or to the risk category appropriate to the institution acquiring the participation, whichever category carries the lower risk weight. Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the pro rata share of the full amount of the assets supported, in whole or in part, by a direct-credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the 20 percent risk category. Risk participations with a remaining maturity of over one year that are conveyed to non-OECD banks are to be assigned to the 100 percent risk category, unless a lower risk category is appropriate to the obligor, guarantor, or collateral.

### *Commitments*

Commitments are defined as any legally binding arrangements that obligate a bank to extend credit in the form of loans or leases; to purchase loans, securities, or other assets; or to participate in loans and leases. Commitments also include overdraft facilities, revolving credit, home equity and mortgage lines of credit, eligible ABCP liquidity facilities, and similar transactions. Normally, commitments involve a written contract or agreement and a commitment fee, or some

other form of consideration. Commitments are included in weighted-risk assets regardless of whether they contain “material adverse change” clauses or other provisions that are intended to relieve the issuer of its funding obligation under certain conditions. In the case of commitments structured as syndications, where the bank is obligated solely for its pro rata share, only the bank’s proportional share of the syndicated commitment is taken into account in calculating the risk-based capital ratio.

*Commitments to make off-balance-sheet transactions.* As specified in the instructions to the Call Report, a commitment to make a standby letter of credit is considered to be a standby letter of credit. Accordingly, such a commitment should be converted to an on-balance-sheet credit-equivalent amount at 100 percent if it is a commitment to make a financial standby letter of credit or at 50 percent if it is a commitment to make a performance standby letter of credit.

A commitment to make a commitment is treated as a single commitment whose maturity is the combined maturity of the two commitments. For example, a 6-month commitment to make a 1-year commitment is considered to be a single 18-month commitment. Since the maturity is over one year, such a commitment would receive the 50 percent conversion factor appropriate to long-term commitments, rather than the zero percent conversion factor that would be accorded to separate unrelated short-term commitments of six months and one year.

A commitment to make a commercial letter of credit may be treated either as a commitment or as a commercial letter of credit, whichever results in the lower conversion factor. Normally, this would mean that a commitment under one year to make a commercial letter of credit would be treated as a commitment and converted at zero percent, while a similar commitment of over one year would be treated as a commercial letter of credit and converted at 20 percent.

If a commitment facility is structured so that it can be drawn down in several forms, such as a standby letter of credit, a loan, or a commercial letter of credit, the entire facility should be treated as a commitment to extend credit in the form that incurs the highest capital charge. Thus, if a facility could be drawn down in any of the three forms just cited, the entire facility would be treated as a commitment to issue a standby letter of credit and would be converted

at 100 percent, rather than treated as a commitment to make a loan or commercial letter of credit, which would have a lower conversion factor.

*Unused commitments.* Except for eligible ABCP liquidity facilities,<sup>42</sup> unused portions of commitments, including underwriting commitments, and commercial and consumer credit commitments that have an original maturity of one year or less are converted at zero percent.

Unused commitments that have an original maturity of over one year are converted at 50 percent. For this purpose, original maturity is defined as the length of time between the date the commitment is issued and the earliest date on which (1) the bank has the permanent ability to, at its option, unconditionally cancel<sup>43</sup> (without cause) the commitment<sup>44</sup> and (2) the bank is scheduled to (and as a normal practice actually does) review the facility to determine whether the unused commitment should be extended. (It should be noted that the term of any loan advances that can be made under a commitment is not taken into account in determining the commitment's maturity.) Under this definition of original maturity, commitments with a nominal original maturity of more than one year can be treated as having a maturity of one year or less for risk-based capital purposes only if the issuing bank (1) has full and unconditional discretion to cancel the commitment without cause and without notice on each and every day after the first year and (2) conducts at least annually a formal credit review of the commitment, including an assessment of the credit quality of the obligor.

It should be noted that a bank is not deemed able to unconditionally cancel a commitment if it is required to give, or is presumed to be required to give, any advance notice of cancellation. Accordingly, so-called evergreen commitments, which require the bank to give

advance notice of cancellation to the obligor or which permit the commitment to roll over automatically (that is, on the same terms and without a thorough credit review) unless the bank gives notice otherwise, are not unconditionally cancelable. Thus, any such commitment whose term from date of issuance could exceed one year is subject to the 50 percent conversion factor.

A bank may issue a commitment that expires within one year, with the understanding that the commitment will be renewed upon expiration subject to a thorough credit review of the obligor. Such a commitment may be converted at zero percent only if (1) the renegotiation process is carried out in good faith, involves a full credit assessment of the obligor, and allows the bank flexibility to alter the terms and conditions of the new commitment; (2) the bank has absolute discretion to decline renewal or extension of the commitment; and (3) the renegotiated commitment expires within 12 months from the time it is made. Some commitments contain unusual renegotiation arrangements that would give the borrower a considerable amount of advance notice that a commitment would not be renewed. Provisions of this kind can have the effect of creating a rolling commitment arrangement that should be treated for risk-based capital purposes as a long-term commitment and should therefore be converted to a credit-equivalent amount at 50 percent. Normally, the renegotiation process should take no more than six to eight weeks, and in many cases it should take a shorter period of time. The renegotiation period should immediately precede the expiration date of the commitment and should be reasonably short and appropriate to the complexity of the transaction. The reasons for provisions in a commitment arrangement that would appear to allow for a protracted renegotiation period should be thoroughly documented by the bank and reviewed by the examiner.

As mentioned above, a commitment to make a commitment is treated as a single commitment whose maturity is the combined maturity of the two commitments. Although such commitments whose combined maturity is in excess of one year are generally considered long-term, if the customer has a bona fide business reason for requesting a new commitment to supersede the unexpired one, such as an unanticipated increase in the volume of business or a change in the customer's cash flow and credit needs, then the commitment would not automatically be consid-

42. Unused portions of eligible ABCP liquidity facilities with an original maturity of one year or less are converted at 10 percent.

43. A bank's option to cancel a commitment under a material adverse change clause is not considered to be an option to unconditionally cancel a commitment.

44. In the case of consumer home equity or mortgage lines of credit secured by liens on one- to four-family residential properties, the bank is deemed able to unconditionally cancel the commitment for the purpose of this criterion if, at its option, it can prohibit additional extensions of credit, reduce the credit lines, and terminate the commitment to the full extent permitted by relevant federal law.

ered long-term. However, if the bank exhibits a pattern and practice of extending short-term commitments before their expiration—either for one customer or more broadly within the bank—then such extended commitments would be viewed as long-term. This treatment generally would apply to all commitments, including traditional commercial paper liquidity lines.

Other criteria for determining whether a facility is short- or long-term include the actual level of risk associated with the transaction and whether that level of risk is more characteristic of a long-term (as opposed to a short-term) commitment. Liquidity facilities issued in connection with asset-backed commercial paper programs, when judged by these criteria, seem to possess risk characteristics that are less than those associated with typical short-term commercial loan commitments. One of these characteristics is the short-term nature of the securitized receivables. The receivables that are securitized in asset-backed commercial paper programs tend to be of very short average maturity—often in the range of 30 to 60 days. Advances under asset-backed commercial paper liquidity facilities generally are very rare, and when such advances are made, it is against pools of very high-quality performing receivables that would generally liquidate very quickly. These facilities are further protected against credit risk by significant amounts of overcollateralization, as well as other credit enhancements.

A series of short-term commitments would generally be treated as a single commitment whose original maturity is the combined maturities of the individual commitments in the series. Also, a commitment may be structured to be drawn down in a number of tranches, some exercisable in one year or less and others exercisable in over one year. The full amount of such a commitment is deemed to be over one year and converted at 50 percent. Some long-term commitments may permit the customer to draw down varying amounts at different times to accommodate, for example, seasonal borrowing needs. The 50 percent conversion factor should be applied to the maximum amount that could be drawn down under such commitments.

### *Credit-Equivalent Computations for Derivative Contracts*

*Applicable derivative contracts.* Credit-equivalent amounts are computed for each of the

following off-balance-sheet contracts:

- interest-rate contracts
  - single-currency interest-rate swaps
  - basis swaps
  - forward rate agreements
  - interest-rate options purchased (including caps, collars, and floors purchased)
  - any other instrument linked to interest rates that gives rise to similar credit risks (including when-issued securities and forward deposits accepted)
- exchange-rate contracts
  - cross-currency interest-rate swaps
  - forward foreign-exchange-rate contracts
  - currency options purchased
  - any other instrument linked to exchange rates that gives rise to similar credit risks
- equity derivative contracts
  - equity-linked swaps
  - equity-linked options purchased
  - forward equity-linked contracts
  - any other instrument linked to equities that gives rise to similar credit risks
- commodity (including precious metal) derivative contracts
  - commodity-linked swaps
  - commodity-linked options purchased
  - forward commodity-linked contracts
  - any other instrument linked to commodities that gives rise to similar credit risks
- credit derivatives
  - credit-default swaps
  - total-rate-of-return swaps
  - other types of credit derivatives

*Exceptions.* Exchange-rate contracts with an original maturity of 14 or fewer calendar days and derivative contracts traded on exchanges that require daily receipt and payment of cash-variation margin may be excluded from the risk-based ratio calculation. Gold contracts are accorded the same treatment as exchange-rate contracts, except that gold contracts with an original maturity of 14 or fewer calendar days are included in the risk-based ratio calculation. Over-the-counter options purchased are included and treated in the same way as other derivative contracts.

*Calculation of credit-equivalent amounts.* The credit-equivalent amount of a derivative contract (excluding credit derivatives) that is not subject to a qualifying bilateral netting contract is equal to the sum of—

Table 5—Conversion-Factor Matrix

<i>Remaining maturity</i>	<i>Interest-rate</i>	<i>Foreign-exchange-rate and gold</i>	<i>Equity</i>	<i>Precious metals (excluding gold)</i>	<i>Other commodity (excluding precious metals)</i>
One year or less	0.0	1.0	6.0	7.0	10.0
Over one to five years	0.5	5.0	8.0	7.0	12.0
Over five years	1.5	7.5	10.0	8.0	15.0

- the current exposure (sometimes referred to as the replacement cost) of the contract, and
- an estimate of the potential future credit exposure of the contract.

The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is equal to that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in the underlying rates, prices, and indexes, as well as in counterparty credit quality.

The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit-conversion factor. Banks should use, subject to examiner review, the effective rather than the apparent or stated notional amount in this calculation. The conversion factors (in percent) are in table 5. The Board has noted that these conversion factors, which are based on observed volatilities of the particular types of instruments, are subject to review and modification in light of changing volatilities or market conditions.

For a contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity is equal to the time until the next reset date. Such resetting interest-rate contracts must have a minimum conversion factor of 0.5 percent.

For a contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the con-

tract. A derivative contract not included in the definitions of interest-rate, exchange-rate, equity, or commodity contracts is included in the risk-based capital calculation and is subject to the same conversion factors as a commodity, excluding precious metals.

No potential future credit exposure is calculated for a single-currency interest-rate swap in which payments are made based on two floating-rate indexes, so-called floating/floating or basis swaps. The credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values.

*Avoidance of double-counting.* In certain cases, credit exposures arising from derivative contracts may be reflected, in part, on the balance sheet. To avoid double counting these exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, examiners may need to exclude counterparty credit exposures arising from the derivative instruments covered by the guidelines from balance-sheet assets when calculating a bank's risk-based capital ratios. This exclusion will eliminate the possibility that an organization could be required to hold capital against both an off-balance-sheet and on-balance-sheet amount for the same item. This treatment is not accorded to margin accounts and accrued receivables related to interest-rate and exchange-rate contracts.

The aggregate on-balance-sheet amount excluded from the risk-based capital calculation is equal to the lower of—

- each contract's positive on-balance-sheet amount, or
- its positive market value included in the off-balance-sheet risk-based capital calculation.



For example, a forward contract that is marked to market will have the same market value on the balance sheet as is used in calculating the credit-equivalent amount for off-balance-sheet exposures under the guidelines. Therefore, the on-balance-sheet amount is not included in the risk-based capital calculation. When either the contract's on-balance-sheet amount or its market value is negative or zero, no deduction from on-balance-sheet items is necessary for that contract.

If the positive on-balance-sheet asset amount exceeds the contract's market value, the excess (up to the amount of the on-balance-sheet asset) should be included in the appropriate risk-weight category. For example, a purchased option will often have an on-balance-sheet amount equal to the fee paid until the option expires. If that amount exceeds market value, the excess of carrying value over market value would be included in the appropriate risk-weight category for purposes of the on-balance-sheet portion of the calculation.

*Netting of swaps and similar contracts.* Netting refers to the offsetting of positive and negative mark-to-market values in the determination of a current exposure to be used in the calculation of a credit-equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of derivative contracts is recognized for purposes of calculating the credit-equivalent amount provided that—

- the netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the organization would have a claim to receive, or an obligation to receive or pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts if a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to default, insolvency, liquidation, or similar circumstances;
- the bank obtains written and reasoned legal opinions that in the event of a legal challenge—including one resulting from default, insolvency, liquidation, or similar circumstances—the relevant court and administrative authorities would find the bank's exposure to be such a net amount under—
  - the law of the jurisdiction in which the counterparty is chartered or the equiva-

lent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

- the law that governs the individual contracts covered by the netting contract; and
- the law that governs the netting contract;
- the bank establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in light of possible changes in relevant law; and
- the bank maintains documentation in its files that is adequate to support the netting of rate contracts, including a copy of the bilateral netting contract and necessary legal opinions.

A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit-equivalent amount.

By netting individual contracts for the purpose of calculating credit-equivalent amounts of derivative contracts, a bank represents that it has met the requirements of the risk-based measure of the capital adequacy guidelines for bank holding companies and that all the appropriate documents are in the organization's files and available for inspection by the Federal Reserve. The Federal Reserve may determine that a bank's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable. If such a determination is made, the netting contract may be disqualified from recognition for risk-based capital purposes, or underlying individual contracts may be treated as though they are not subject to the netting contract.

The credit-equivalent amount of contracts that are subject to a qualifying bilateral netting contract is calculated by adding—

- the current exposure of the netting contract (net current exposure), and
- the sum of the estimates of the potential future credit exposures on all individual contracts subject to the netting contract (gross potential future exposure), adjusted to reflect the effects of the netting contract.

The net current exposure of the netting contract is determined by summing all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is

positive, then the current exposure of the netting contract is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the current exposure of the netting contract is zero. The Federal Reserve may determine that a netting contract qualifies for risk-based capital netting treatment even though certain individual contracts may not qualify. In these instances, the nonqualifying contracts should be treated as individual contracts that are not subject to the netting contract.

Gross potential future exposure ( $A_{\text{gross}}$ ) is calculated by summing the estimates of potential future exposure for each individual contract subject to the qualifying bilateral netting contract. The effects of the bilateral netting contract on the gross potential future exposure are recognized through the application of a formula that results in an adjusted add-on amount ( $A_{\text{net}}$ ). The formula, which employs the ratio of net current exposure to gross current exposure (NGR), is expressed as—

$$A_{\text{net}} = (0.4 \times A_{\text{gross}}) + 0.6(\text{NGR} \times A_{\text{gross}})$$

The NGR may be calculated in accordance with either the counterparty-by-counterparty approach or the aggregate approach. Under the counterparty-by-counterparty approach, the NGR is the ratio of the net current exposure for a netting contract to the gross current exposure of the netting contract. The gross current exposure is the sum of the current exposures of all individual contracts subject to the netting contract. Net negative mark-to-market values for individual netting contracts with the same counterparty may not be used to offset net positive mark-to-market values for other netting contracts with the same counterparty.

Under the aggregate approach, the NGR is the ratio of the sum of all the net current exposures for qualifying bilateral netting contracts to the sum of all the gross current exposures for those netting contracts (each gross current exposure is calculated in the same manner as in the counterparty-by-counterparty approach). Net negative mark-to-market values for individual counterparties may not be used to offset net positive current exposures for other counterparties.

A bank must consistently use either the counterparty-by-counterparty approach or the aggregate approach to calculate the NGR. Regardless of the approach used, the NGR should be applied individually to each qualify-

ing bilateral netting contract to determine the adjusted add-on for that netting contract.

In the event a netting contract covers contracts that are normally excluded from the risk-based ratio calculation—for example, exchange-rate contracts with an original maturity of 14 or fewer calendar days or instruments traded on exchanges that require daily payment and receipt of cash-variation margin—an institution may elect to either include or exclude all mark-to-market values of such contracts when determining net current exposure, provided the method chosen is applied consistently.

Examiners should review the netting of off-balance-sheet derivative contracts used by banks when calculating or verifying risk-based capital ratios to ensure that the positions of such contracts are reported gross, unless the net positions of those contracts reflect netting arrangements that comply with the netting requirements listed previously.

### *Credit Derivatives*

Credit derivatives are off-balance-sheet arrangements that allow one party (the beneficiary) to transfer credit risk of a reference asset—which the beneficiary may or may not own—to another party (the guarantor).<sup>45</sup> Many banks increasingly use these instruments to manage their overall credit-risk exposure. In general, credit derivatives have three distinguishing features:

- the transfer of the credit risk associated with a reference asset through contingent payments based on events of default and, usually, the prices of instruments before, at, and shortly after default (reference assets most often take the form of traded sovereign and corporate debt instruments or syndicated bank loans)
- the periodic exchange of payments or the payment of a premium rather than the payment of fees customary with other off-balance-sheet credit products, such as letters of credit
- the use of an International Swap Derivatives Association (ISDA) master agreement and the legal format of a derivatives contract

45. Credit derivatives generally fall into three basic transaction types: total-rate-of-return swaps, credit-default swaps, and credit-default or credit-linked notes. For a more in-depth description of these types of credit derivatives, see the Federal Reserve's *Trading and Capital-Markets Activities Manual*, section 4350.1, "Credit Derivatives," as well as SR-96-17.

For risk-based capital purposes, total-rate-of-return swaps and credit-default swaps generally should be treated as off-balance-sheet direct-credit substitutes.<sup>46</sup> The notional amount of a contract should be converted at 100 percent to determine the credit-equivalent amount to be included in the risk-weighted assets of a guarantor.<sup>47</sup> A bank that provides a guarantee through a credit derivative transaction should assign its credit exposure to the risk category appropriate to the obligor of the reference asset or any collateral. On the other hand, a bank that owns the underlying asset upon which effective credit protection has been acquired through a credit derivative may, under certain circumstances, assign the unamortized portion of the underlying asset to the risk category appropriate to the guarantor (for example, the 20 percent risk category if the guarantor is an OECD bank).

Whether the credit derivative is considered an eligible guarantee for purposes of risk-based capital depends on the actual degree of credit protection. The amount of credit protection actually provided by a credit derivative may be limited depending on the terms of the arrangement. In this regard, for example, a relatively restrictive definition of a default event or a materiality threshold that requires a comparably high percentage of loss to occur before the guarantor is obliged to pay could effectively limit the amount of credit risk actually transferred in the transaction. If the terms of the credit derivative arrangement significantly limit the degree of risk transference, then the beneficiary bank cannot reduce the risk weight of the “protected” asset to that of the guarantor bank. On the other hand, even if the transfer of credit risk is limited, a bank providing limited credit protection through a credit derivative should hold appropriate capital against the underlying exposure while it is exposed to the credit risk of the reference asset.

A bank providing a guarantee through a credit derivative may mitigate the credit risk associated with the transaction by entering into an offsetting credit derivative with another counterparty—a so-called back-to-back position. A bank that has entered into such a position may treat the first credit derivative as being guaranteed by the offsetting transaction for risk-based capital purposes. Accordingly, the notional amount of the first credit derivative may be assigned to the risk category appropriate to the counterparty providing credit protection through the offsetting credit derivative arrangement (for example, the 20 percent risk category if the counterparty is an OECD bank).

In some instances, the reference asset in the credit derivative transaction may not be identical to the underlying asset for which the beneficiary has acquired credit protection. For example, a credit derivative used to offset the credit exposure of a loan to a corporate customer may use as the reference asset a publicly traded corporate bond of that customer, with the credit quality of the bond serving as a proxy for the on-balance-sheet loan. In such a case, the underlying asset would still generally be considered guaranteed for capital purposes, as long as both the underlying asset and the reference asset are obligations of the same legal entity and have the same level of seniority in bankruptcy. In addition, a bank offsetting credit exposure in this manner would be obligated to demonstrate to examiners that (1) there is a high degree of correlation between the two instruments; (2) the reference instrument is a reasonable and sufficiently liquid proxy for the underlying asset so that the instruments can be reasonably expected to behave in a similar manner in the event of default; and (3) at a minimum, the reference asset and underlying asset are subject to mutual cross-default provisions. A bank that uses a credit derivative that is based on a reference asset that differs from the protected underlying asset must document the credit derivative being used to offset credit risk, and must link it directly to the asset or assets whose credit risk the transaction is designed to offset. The documentation and the effectiveness of the credit derivative transaction are subject to examiner review. A bank providing credit protection through such an arrangement must hold capital against the risk exposures that are assumed.

Some credit derivative transactions provide credit protection for a group or basket of reference assets and call for the guarantor to absorb

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46. Unlike total-rate-of-return swaps and credit-default swaps, credit-linked notes are on-balance-sheet assets or liabilities. A guarantor bank should assign the on-balance-sheet amount of the credit-linked note to the risk category appropriate to either the issuer or the reference asset, whichever is higher. For a beneficiary bank, cash consideration received in the sale of the note may be considered as collateral for risk-based capital purposes.

47. A guarantor bank that has made cash payments representing depreciation on reference assets may deduct such payments from the notional amount when computing credit-equivalent amounts for capital purposes.

losses on only the first asset in the group that defaults. Once the first asset in the group defaults, the credit protection for the remaining assets covered by the credit derivative ceases. If examiners determine that the credit risk for the basket of assets has effectively been transferred to the guarantor and the beneficiary banking organization owns all of the reference assets included in the basket, then the beneficiary may assign the asset with the smallest dollar amount in the group—if less than or equal to the notional amount of the credit derivative—to the risk category appropriate to the guarantor. Conversely, a bank extending credit protection through a credit derivative on a basket of assets must assign the contract's notional amount of credit exposure to the highest risk category appropriate to the assets in the basket.

In addition to holding capital against credit risk, a bank that is subject to the market-risk rule (see “Market-Risk Measure” earlier in this section) must hold capital against market risk for credit derivatives held in its trading account. (For a description of market-risk capital requirements for credit derivatives, see SR-97-18.)

### *Using Credit Derivatives to Synthetically Replicate Collateralized Loan Obligations*

Credit derivatives can be used to synthetically replicate collateralized loan obligations (CLOs). Banking organizations (BOs) can use CLOs and their synthetic variants to manage their balance sheets and, in some instances, transfer credit risk to the capital markets. Such transactions allow economic capital to be more efficiently allocated, resulting in, among other things, improved shareholders' returns.

The issue for BOs is how synthetic CLOs should be treated under the risk-based and leverage capital guidelines.<sup>48</sup> Supervisors and examiners need to fully understand these complex structures and identify the relative degree of transference and retention of the securitized portfolio's credit risk. They must determine whether the institution's regulatory capital is adequate given the retained credit exposures.

A CLO is an asset-backed security that is usually supported by a variety of assets, including whole commercial loans, revolving-credit

facilities, letters of credit, banker's acceptances, or other asset-backed securities. In a typical CLO transaction, the sponsoring banking organization (SBO) transfers the loans and other assets to a bankruptcy-remote special-purpose vehicle (SPV), which then issues asset-backed securities consisting of one or more classes of debt. This type of transaction represents a so-called cash-flow CLO. It enables the sponsoring institution (SI) to reduce its leverage and risk-based capital requirements, improve its liquidity, and manage credit concentrations.

The first synthetic CLO (issued in 1997) used credit-linked notes (CLNs).<sup>49</sup> Rather than transferring assets to the SPV, the sponsoring bank issued CLNs to the SPV, individually referencing the payment obligation of a particular company, or “reference obligor.” The notional amount of the CLNs issued equaled the dollar amount of the reference assets the sponsor was hedging on its balance sheet. Other structures have evolved that use credit-default swaps to transfer credit risk and create different levels of risk exposure, but that hedge only a portion of the notional amount of the overall reference portfolio.<sup>50</sup>

Traditional CLO structures usually transfer assets into the SPV. In synthetic securitizations, the underlying exposures that make up the reference portfolio remain in the institution's banking book.<sup>51</sup> The credit risk is transferred into the SPV through credit-default swaps or CLNs. The institution is thus able to maintain client confidentiality and avoid sensitive client-relationship issues that arise from loan-transfer-notification requirements, loan-assignment provisions, and loan-participation restrictions.

Corporate credits are assigned to the 100 percent risk-weighted asset category. In the case of high-quality investment-grade corporate exposures, the associated 8 percent capital requirement may exceed the economic capital that the sponsoring bank sets aside to cover the credit

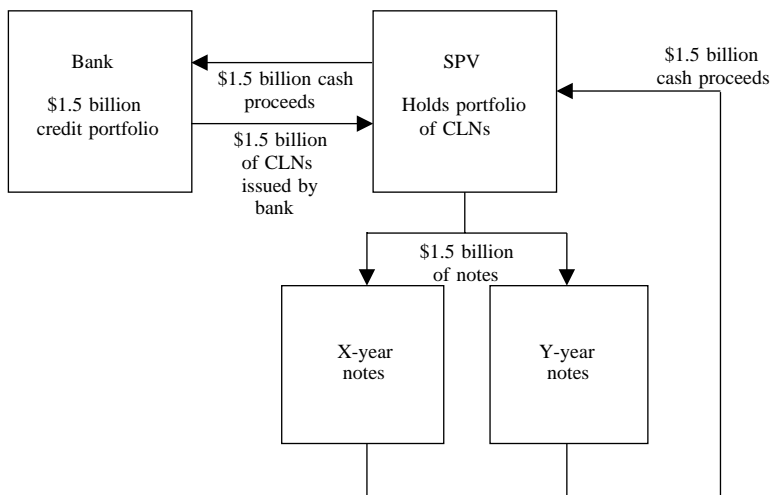
49. CLNs are obligations whose principal repayment is conditioned upon the performance of a referenced asset or portfolio. The assets' performance may be based on a variety of measures, such as movements in price or credit spread, or the occurrence of default.

50. A credit-default swap is similar to a financial standby letter of credit in that the institution writing the swap provides, for a fee, credit protection against credit losses associated with a default on a specified reference asset or pool of assets.

51. “Banking book” refers to nontrading accounts. See the definition of “trading accounts” in the glossary for the instructions to the bank Call Report.

48. See SR-99-32 and its November 15, 1999, attachment, an FRB-OCC capital interpretation on synthetic CLOs.

Figure 1—Transaction 1



risk of the transaction. Therefore, one of the apparent motivations behind CLOs and other securitizations is to more closely align the SI's regulatory capital requirements with the economic capital required by the market.

Synthetic CLOs can raise questions about their capital treatment when calculating the risk-based and leverage capital ratios. Capital treatments for three synthetic CLO transactions follow. They are discussed from the perspective of the investors and the SBOs.

*Transaction 1—Entire notional amount of the reference portfolio is hedged.* In the first type of synthetic securitization, the SBO, through a synthetic CLO, hedges the entire notional amount of a reference-asset portfolio. An SPV acquires the credit risk on a reference portfolio by purchasing CLNs issued by the SBO. The SPV funds the purchase of the CLNs by issuing a series of notes in several tranches to third-party investors. The investor notes are in effect collateralized by the CLNs. Each CLN represents one obligor and the bank's credit-risk exposure to that obligor, which could take the form of bonds, commitments, loans, and counterparty exposures. Since the noteholders are exposed to the full amount of credit risk associated with the individual reference obligors, all of the credit risk of the reference portfolio is shifted from the sponsoring bank to the capital markets. The dollar amount of notes issued to investors equals the notional amount of the reference portfolio.

In the example shown in figure 1, this amount is \$1.5 billion.

If any obligor linked to a CLN in the SPV defaults, the SI will call the individual CLN and redeem it based on the repayment terms specified in the note agreement. The term of each CLN is set so that the credit exposure (to which it is linked) matures before the maturity of the CLN, which ensures that the CLN will be in place for the full term of the exposure to which it is linked.

An investor in the notes issued by the SPV is exposed to the risk of default of the underlying reference assets, as well as to the risk that the SI will not repay principal at the maturity of the notes. Because of the linkage between the credit quality of the SI and the issued notes, a downgrade of the sponsor's credit rating most likely will result in the notes also being downgraded. Thus, a BO investing in this type of synthetic CLO should assign the notes to the higher of the risk categories appropriate to the underlying reference assets or the issuing entity.

For purposes of risk-based capital, the SBOs may treat the cash proceeds from the sale of CLNs that provide protection against underlying reference assets as cash collateralizing these assets.<sup>52</sup> This treatment would permit the refer-

52. The CLNs should not contain terms that would significantly limit the credit protection provided against the underlying reference assets, for example, a materiality threshold that requires a relatively high percentage of loss to occur

ence assets, if carried on the SI's books, to be assigned to the zero percent risk category to the extent that their notional amount is fully collateralized by cash. This treatment may be applied even if the cash collateral is transferred directly into the general operating funds of the institution and is not deposited in a segregated account. The synthetic CLO would not confer any benefits to the SBO for purposes of calculating its tier 1 leverage ratio because the reference assets remain on the organization's balance sheet.

*Transaction 2—High-quality, senior risk position in the reference portfolio is retained.* In the second type of synthetic CLO transaction, the SBO hedges a portion of the reference portfolio and retains a high-quality, senior risk position that absorbs only those credit losses in excess of the junior-loss positions. In some recent synthetic CLOs, the SBO has used a combination of credit-default swaps and CLNs to essentially transfer to the capital markets the credit risk of a designated portfolio of the organization's credit exposures. Such a transaction allows the SI to allocate economic capital more efficiently and to significantly reduce its regulatory capital requirements.

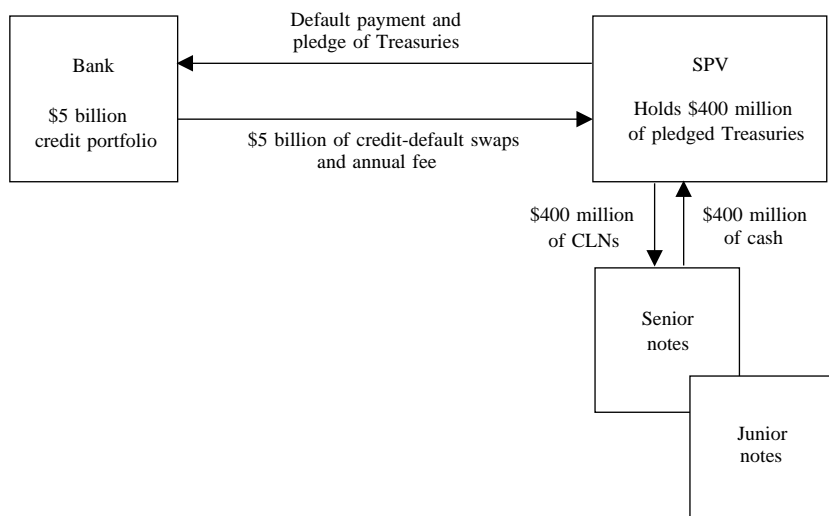
before CLN payments are adversely affected, or a structuring of CLN post-default payments that does not adequately pass through credit-related losses on the reference assets to investors in the CLNs.

In the structure illustrated in figure 2, the SBO purchases default protection from an SPV for a specifically identified portfolio of banking-book credit exposures, which may include letters of credit and loan commitments. The credit risk on the identified reference portfolio (which continues to remain in the sponsor's banking book) is transferred to the SPV through the use of credit-default swaps. In exchange for the credit protection, the SI pays the SPV an annual fee. The default swaps on each of the obligors in the reference portfolio are structured to pay the average default losses on all senior unsecured obligations of defaulted borrowers.

To support its guarantee, the SPV sells CLNs to investors and uses the cash proceeds to purchase U.S. government Treasury notes. The SPV then pledges the Treasuries to the SBO to cover any default losses.<sup>53</sup> The CLNs are often issued in multiple tranches of differing seniority and in an aggregate amount that is significantly less than the notional amount of the reference portfolio. The amount of notes issued typically is set at a level sufficient to cover some multiple of expected losses, but well below the notional amount of the reference portfolio being hedged.

53. The names of corporate obligors included in the reference portfolio may be disclosed to investors in the CLNs.

Figure 2—Transaction 2



There may be several levels of loss in this type of synthetic securitization. The first-loss position may consist of a small cash reserve, sufficient to cover expected losses. The cash reserve accumulates over a period of years and is funded from the excess of the SPV's income (that is, the yield on the Treasury securities plus the credit-default-swap fee) over the interest paid to investors on the notes. The investors in the SPV assume a second-loss position through their investment in the SPV's senior and junior notes, which tend to be rated AAA and BB, respectively. Finally, the SBO retains a high-quality, senior risk position that would absorb any credit losses in the reference portfolio that exceed the first- and second-loss positions.

Typically, no default payments are made until the maturity of the overall transaction, regardless of when a reference obligor defaults. While operationally important to the SBO, this feature has the effect of ignoring the time value of money. Thus, the Federal Reserve expects that when the reference obligor defaults under the terms of the credit derivative and when the reference asset falls significantly in value, the SBO should, in accordance with GAAP, make appropriate adjustments in its regulatory reports to reflect the estimated loss that takes into account the time value of money.

For risk-based capital purposes, BOs investing in the notes must assign them to the risk weight appropriate to the underlying reference assets.<sup>54</sup> The SBO for such transactions must include in its risk-weighted assets its retained senior exposure in the reference portfolio, to the extent these underlying assets are held in its banking book. The portion of the reference portfolio that is collateralized by the pledged Treasury securities may be assigned a zero percent risk weight. Unless the SBO meets the stringent minimum conditions for transaction 2 that are outlined in the minimum conditions explanation below, the remainder of the portfolio should be risk-weighted according to the obligor of the exposures.

When the SI has virtually eliminated its credit-risk exposure to the reference portfolio through the issuance of CLNs, and when the other stringent minimum conditions are met, the institution may assign the uncollateralized por-

tion of its retained senior position in the reference portfolio to the 20 percent risk weight. However, to the extent that the reference portfolio includes loans and other on-balance-sheet assets, an SBO involved in such a synthetic securitization would not realize any benefits in the determination of its leverage ratio.

In addition to the three stringent minimum conditions, the Federal Reserve may impose other requirements as it deems necessary to ensure that the SI has virtually eliminated all of its credit exposure. Furthermore, the Federal Reserve retains the discretion to increase the risk-based capital requirement assessed against the retained senior exposure in these structures, if the underlying asset pool deteriorates significantly.

Federal Reserve staff will make a case-by-case determination, based on a qualitative review, as to whether the senior retained portion of an SBO's synthetic securitization qualifies for the 20 percent risk weight. The SI must be able to demonstrate that virtually all the credit risk of the reference portfolio has been transferred from the banking book to the capital markets. As they do when BOs are engaging in more traditional securitization activities, examiners must carefully evaluate whether the institution is fully capable of assessing the credit risk it retains in its banking book and whether it is adequately capitalized given its residual risk exposure. The Federal Reserve will require the SBO to maintain higher levels of capital if it is not deemed to be adequately capitalized given the retained residual risks. In addition, an SI involved in synthetic securitizations must adequately disclose to the marketplace the effect of the transaction on its risk profile and capital adequacy.

The Federal Reserve may consider an SBO's failure to require the investors in the CLNs to absorb the credit losses that they contractually agreed to assume to be an unsafe and unsound banking practice. In addition, such a failure generally would constitute "implicit recourse" or support to the transaction, which would result in the SBO's losing preferential capital treatment on its retained senior position.

If an SBO of a synthetic securitization does not meet the stringent minimum conditions, it may still reduce the risk-based capital requirement on the senior risk position retained in the banking book by transferring the remaining credit risk to a third-party OECD bank through the use of a credit derivative. Provided the credit derivative transaction qualifies as a guarantee

54. Under this type of transaction, if a structure exposes investing BOs to the creditworthiness of a substantive issuer, for example, the SI, then the investing institutions should assign the notes to the higher of the risk categories appropriate to the underlying reference assets or the SI.

under the risk-based capital guidelines, the risk weight on the senior position may be reduced from 100 percent to 20 percent. Institutions may not enter into nonsubstantive transactions that transfer banking-book items into the trading account to obtain lower regulatory capital requirements.<sup>55</sup>

*Minimum conditions.* The following stringent minimum conditions are those that SIs must meet to use the synthetic securitization capital treatment for transaction 2. The Federal Reserve may impose additional requirements or conditions as deemed necessary to ascertain that the SBO has sufficiently isolated itself from the credit-risk exposure of the hedged reference portfolio.

- *Condition 1—Demonstration of transfer of virtually all of the risk to third parties.* Not all transactions structured as synthetic securitizations transfer the level of credit risk needed to receive the 20 percent risk weight on the retained senior position. To demonstrate that a transfer of virtually all of the risk has been achieved, institutions must—
  - produce credible analyses indicating a transfer of virtually all of the credit risk to substantive third parties;
  - ensure the absence of any early-amortization or other credit performance-contingent clauses;<sup>56</sup>
  - subject the transaction to market discipline through the issuance of a substantive amount of notes or securities to the capital markets;
  - have notes or securities rated by a nationally recognized credit rating agency;
  - structure a senior class of notes that receives the highest possible investment-grade rating, for example, AAA, from a nationally recognized credit rating agency;
  - ensure that any first-loss position retained by the SI in the form of fees, reserves, or

other credit enhancements—which effectively must be deducted from capital—is no greater than a reasonable estimate of expected losses on the reference portfolio; and

- ensure that the SI does not reassume any credit risk beyond the first-loss position through another credit derivative or any other means.
- *Condition 2—Demonstration of ability to evaluate remaining banking-book risk exposures and provide adequate capital support.* To ensure that the SI has adequate capital for the credit risk of its unhedged exposures, an institution is expected to have adequate systems that fully account for the effect of those transactions on its risk profiles and capital adequacy. In particular, its systems should be capable of fully differentiating the nature and quality of the risk exposures an institution transfers from the nature and quality of the risk exposures it retains. Specifically, to gain capital relief institutions are expected to—
  - have a credible internal process for grading credit-risk exposures, including (1) adequate differentiation of risk among risk grades, (2) adequate controls to ensure the objectivity and consistency of the rating process, and (3) analysis or evidence supporting the accuracy or appropriateness of the risk-grading system;
  - have a credible internal economic capital-assessment process that defines the institution to be adequately capitalized at an appropriate insolvency probability and that readjusts, as necessary, its internal economic capital requirements to take into account the effect of the synthetic-securitization transaction. In addition, the process should employ a sufficiently long time horizon to allow necessary adjustments in the event of significant losses. The results of an exercise demonstrating that the organization is adequately capitalized after the securitization transaction must be presented for examiner review;
  - evaluate the effect of the transaction on the nature and distribution of the nontransferred banking-book exposures. This analysis should include a comparison of the banking book's risk profile and economic capital requirements before and after the transaction, including the mix of exposures by risk grade and business or economic sector. The analysis should also

55. For instance, a lower risk weight would not be applied to a nonsubstantive transaction in which the SI (1) enters into a credit derivative transaction to pass the credit risk of the senior retained portion held in its banking book to an OECD bank and then (2) enters into a second credit derivative transaction with the same OECD bank, in which it reassumes into its trading account the credit risk initially transferred.

56. Early-amortization clauses may generally be defined as features that are designed to force a wind-down of a securitization program and rapid repayment of principal to asset-backed securities investors if the credit quality of the underlying asset pool deteriorates significantly.



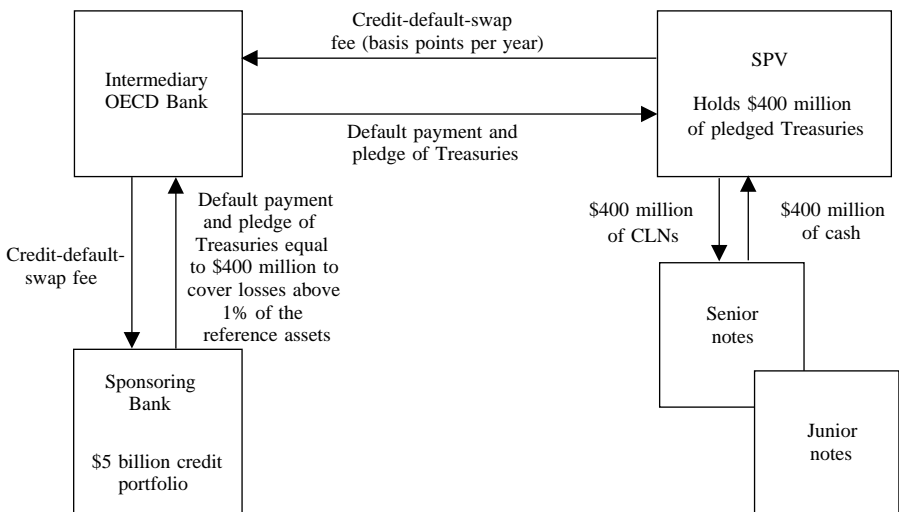
- identify any concentrations of credit risk and maturity mismatches. Additionally, the bank must adequately manage and control the forward credit exposure that arises from any maturity mismatch. The Federal Reserve retains the flexibility to require additional regulatory capital if the maturity mismatches are substantive enough to raise a supervisory concern. Moreover, as stated above, the SBO must demonstrate that it meets its internal economic capital requirement subsequent to the completion of the synthetic securitization; and
  - perform rigorous and robust forward-looking stress testing on nontransferred exposures (remaining banking-book loans and commitments), transferred exposures, and exposures retained to facilitate transfers (credit enhancements). The stress tests must demonstrate that the level of credit enhancement is sufficient to protect the sponsoring bank from losses under scenarios appropriate to the specific transaction.
- *Condition 3—Provide adequate public disclosures of synthetic CLO transactions regarding their risk profile and capital adequacy.* In their

10-K and annual reports, SIs must adequately disclose to the marketplace the accounting, economic, and regulatory consequences of synthetic CLO transactions. In particular, institutions are expected to disclose—

- the notional amount of loans and commitments involved in the transaction;
- the amount of economic capital shed through the transaction;
- the amount of reduction in risk-weighted assets and regulatory capital resulting from the transaction, both in dollar terms and in terms of the effect in basis points on the risk-based capital ratios; and
- the effect of the transaction on the distribution and concentration of risk in the retained portfolio by risk grade and sector.

*Transaction 3—Retention of a first-loss position.* In the third type of synthetic transaction, the SBO may retain a subordinated position that absorbs first losses in a reference portfolio. The SBO retains the credit risk associated with a first-loss position and, through the use of credit-default swaps, passes the second- and senior-loss positions to a third-party entity, most often an OECD bank. The third-party entity, acting as an intermediary, enters into offsetting credit-

Figure 3—Transaction 3



default swaps with an SPV, thus transferring its credit risk associated with the second-loss position to the SPV.<sup>57</sup> The SPV then issues CLNs to the capital markets for a portion of the reference portfolio and purchases Treasury collateral to cover some and multiple of expected losses on the underlying exposures. (See figure 3.)

Two alternative approaches could be used to determine how the SBO should treat the overall transaction for risk-based capital purposes. The first approach employs an analogy to the low-level capital rule for assets sold with recourse. Under this rule, a transfer of assets with recourse that contractually is limited to an amount less than the effective risk-based capital requirements for the transferred assets is assessed a total capital charge equal to the maximum amount of loss possible under the recourse obligation. If this rule was applied to an SBO retaining a 1 percent first-loss position on a synthetically securitized portfolio that would otherwise be assessed 8 percent capital, the SBO would be required to hold dollar-for-dollar capital against the 1 percent first-loss risk position. The SI would not be assessed a capital charge against the second and senior risk positions.<sup>58</sup>

The second approach employs a literal reading of the capital guidelines to determine the SBO's risk-based capital charge. In this instance, the one percent *first-loss position* retained by the SI would be treated as a guarantee, that is, a direct-credit substitute, which would be assessed an 8 percent capital charge against its face value of one percent. The *second-loss position*, which is collateralized by Treasury securities, would be viewed as fully collateralized and subject to a zero percent capital charge. The senior-loss position guaranteed by the intermediary bank would be assigned to the 20 percent risk category appropriate to claims guaranteed by OECD banks.<sup>59</sup>

It is possible that the second approach may result in a higher risk-based capital requirement than the dollar-for-dollar capital charge imposed by the first approach. This depends on whether the reference portfolio consists primarily of loans to private obligors or of undrawn long-term commitments, which generally have an effective risk-based capital requirement that is one-half of the requirement for loans, since such commitments are converted to an on-balance-sheet credit-equivalent amount using the 50 percent conversion factor. If the reference pool consists primarily of drawn loans to private obligors, then the capital requirement on the senior loss position would be significantly higher than if the reference portfolio contained only undrawn long-term commitments. As a result, the capital charge for the overall transaction could be greater than the dollar-for-dollar capital requirement set forth in the first approach.

SIs will be required to hold capital against a retained first-loss position in a synthetic securitization equal to the higher of the two capital charges resulting from application of the first and second approaches, as discussed above. Further, although the SBO retains only the credit risk associated with the first-loss position, it still should continue to monitor all the underlying credit exposures of the reference portfolio to detect any changes in the credit-risk profile of the counterparties. This is important to ensure that the institution has adequate capital to protect against unexpected losses. Examiners should determine whether the sponsoring bank has the capability to assess and manage the retained risk in its credit portfolio after the synthetic securitization is completed. For risk-based capital purposes, BOs investing in the notes must assign them to the risk weight appropriate to the underlying reference assets.<sup>60</sup>

## Reservation of Authority

The Federal Reserve reserves its authority to determine, on a case-by-case basis, the appropriate risk weight for assets and credit-equivalent

57. Because the credit risk of the senior position is not transferred to the capital markets but remains with the intermediary bank, the SBO should ensure that its counterparty is of high credit quality, for example, at least investment grade.

58. A BO that sponsors this type of synthetic securitization would not realize any benefits with respect to the determination of its leverage ratio since the reference assets remain on the SI's balance sheet.

59. If the intermediary is a BO, then it could place both sets of credit-default swaps in its trading account and, if subject to the Federal Reserve's market-risk capital rules, use its general-market-risk model and, if approved, specific-risk model to calculate the appropriate risk-based capital requirement. If the specific-risk model has not been approved, then the SBO

would be subject to the standardized specific-risk capital charge.

60. Under this type of transaction, if a structure exposes investing BOs to the creditworthiness of a substantive issuer, for example, the SI, then the investing institutions should assign the notes to the higher of the risk categories appropriate to the underlying reference assets or the SI.

amounts and the appropriate credit-conversion factor for off-balance-sheet items. The Federal Reserve's exercise of this authority may result in a higher or lower risk weight for an asset or credit-equivalent amount, or in a higher or lower credit-conversion factor for an off-balance-sheet item. This reservation of authority explicitly recognizes that the Federal Reserve retains sufficient discretion to ensure that banks, as they develop novel financial assets, will be treated appropriately under the regulatory capital standards. Under this authority, the Federal Reserve reserves its right to assign risk positions in securitizations to appropriate risk categories on a case-by-case basis, if the credit rating of the risk position is determined to be inappropriate.

#### *Board Approved Exceptions to Risk-Based Capital Guidelines (Reservation of Authority) Involving Securities Lending*

Securities lent by a bank are treated in one of two ways, depending upon whether the lender is at risk of loss. If a bank, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the transaction is excluded from the risk-based capital calculation. Alternatively, if a bank lends its own securities or, acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk-weight category appropriate to the obligor, or, if applicable, to any collateral delivered to the lending bank or the independent custodian acting on the lending bank's behalf. When a bank is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the bank, the transaction is deemed to be collateralized by cash on deposit for purposes of determining the appropriate risk-weight category, provided that (1) any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and (2) any reinvestment risk associated with that cash collateral is borne by the customer. See the "Risk-Weighting Process" discussion in this section and also the discussion in section 2030.1 on bank dealer securities-lending or -borrowing transactions.

*Certain agency securities-lending arrangements (May 2003 exception for "cash-collateral transactions").* In response to a bank's inquiry, the Board issued a May 14, 2003, interpretation for the risk-based capital treatment of certain European agency securities' lending arrangements in which the bank, acting as agent, lends securities of a client and receives cash collateral from the borrower. The transaction is marked-to-market daily and a positive margin of cash collateral relative to the market value of the securities lent is maintained at all times. If the borrowing counterparty defaults on the securities loaned through, for example, failure to post margin when required, the transaction is immediately terminated and the cash collateral is used by the bank to repurchase in the market the securities lent in order to restore them to the client. The bank indemnifies its client against the risk that, in the event of counterparty default, the amount of cash collateral may be insufficient to repurchase the amount of securities lent. Thus, the indemnification is limited to the difference between the value of the cash collateral and the repurchase price of the replacement securities. In addition, the bank, again acting as agent, reinvests, on the client's behalf, the cash collateral received from the borrower. The reinvestment transaction takes the form of a cash loan to a counterparty that is fully collateralized by government or corporate securities (through, for example, a reverse repurchase agreement). Like the first transaction, the reinvestment transaction is subject to daily marking-to-market and remarking and is immediately terminable in the event of counterparty default. The bank issues an indemnification to the client against the reinvestment risk, which is similar to the indemnification the bank gives on the original securities-lending transaction.

The Federal Reserve Board's current risk-based capital guidelines treat indemnifications issued in connection with agency securities-lending activities as off-balance-sheet guarantees that are subject to capital charges. Under the guidelines, the bank's first indemnification would receive the risk weight of the securities-borrowing counterparty because of the bank's indemnification of the client's reinvestment risk on the cash collateral. (See 12 CFR 208, appendix A, section III.D.1.c.) The bank's second indemnification would receive the lower of the risk weight of the reverse repurchase counterparty or the collateral, unless it was fully collateralized with margin by OECD government

securities, which would qualify for a zero percent risk weight. (See 12 CFR 208, appendix A, sections III.D.1.a. and b.)

The bank inquired about the possibility of assigning a zero percent risk weight for both indemnifications, given the low risk they pose to the bank. The Board approved an exception to its risk-based capital guidelines for the bank's agency securities-lending transactions. The Board approved this exception under the reservation of authority provision contained in the guidelines. This provision permits the Board, on a case-by-case basis, to determine the appropriate risk weight for any asset or off-balance-sheet item that imposes risks on a bank that are incommensurate with the risk weight otherwise specified in the guidelines. (See 12 CFR 208, appendix A, section III.A.)

This exception applies to the bank's agency securities-lending transactions collateralized by cash where the bank indemnifies its client against (1) the risk that, in the event of default by the securities borrower, the amount of cash collateral may be insufficient to repurchase the amount of securities lent and (2) the reinvestment risk associated with lending the cash collateral in a transaction fully collateralized by securities (for example, in a reverse repurchase transaction).

The capital treatment the Board approved for these transactions relies upon an economic measurement of the amount of risk exposure the bank has to each of its counterparties. Under this approved approach, the bank does not use the notional amount of underlying transactions that are subject to client indemnifications as the exposure amount for risk-based capital purposes. Rather, the bank must use an economic exposure amount that takes into account the market value of collateral and the market price volatilities of (1) the instruments delivered by the bank to the counterparty and (2) the instruments received by the bank from the counterparty. This approach builds on best practices of banks for measuring their credit exposure amounts for purposes of managing internal single-borrower exposure limits, as well as upon existing concepts incorporated in the Basel Accord and the Board's risk-based capital and market risk rules. The bank, under this exception, is required to determine an unsecured loan equivalent amount for each of the counterparties to which, as agent, the bank lends securities collateralized by cash or lends cash collateralized by securities. As described below, the

unsecured loan equivalent amount will be assigned the risk weight appropriate to the counterparty.

To determine the unsecured loan equivalent amount, the bank must add together its current exposure to the counterparty and a measure for potential future exposure (PFE) to the counterparty. The current exposure is the sum of the market value of all securities and cash lent to the counterparty under the bank's indemnified arrangements, less the sum of all securities and cash received from the counterparty as collateral under the indemnified arrangements. The PFE calculation is to be based on the market volatilities of the securities lent and the securities received, as well as any foreign exchange rate volatilities associated with any cash or securities lent or received.

The Board considered two methods for incorporating market volatilities into the PFE calculation: (1) the bank's own estimates of those volatilities based on a year's historical observation of market prices with no recognition of correlation effects or (2) a value-at-risk (VaR) type model. The bank was calculating daily, counterparty VAR estimates for its agency lending transactions and it had a VaR model that had been approved for purposes of the Board's market risk rule. The Board determined that the bank could use a VaR model to calculate the PFE for each of its counterparties.

The bank must calculate the VaR using a five-day holding period and a 99th percentile one-tailed confidence interval based on market price data over a one-year historical observation period. The data set used should be updated no less frequently than once every three months and should be reassessed whenever market prices are subject to material changes. For each counterparty, the bank is required to calculate daily an unsecured loan equivalent amount, including the VaR PFE component. These calculations will be subject to supervisory review to ensure they are in line with the quarter-end calculations used to determine regulatory capital requirements.

To qualify for the capital treatment outlined above, the securities-lending and cash loan transactions covered by the bank's indemnification must meet the following conditions:

- the transactions are fully collateralized
- any securities lent or taken as collateral are eligible for inclusion in the trading book and are liquid and readily marketable

- any securities lent or taken as collateral are marked-to-market daily
- the transactions are subject to a daily margin maintenance requirement

Further, the transactions must be executed under a bilateral netting agreement or an equivalent arrangement. These arrangements must (1) provide the non-defaulting party the right to promptly terminate and close out all transactions under the agreement upon an event of default, including insolvency or bankruptcy of the counterparty; (2) provide for the netting of gains and losses on transactions (including the value of any collateral) terminated and closed out under the agreement so that a single net amount is owed by one party to the other; (3) allow for the prompt liquidation or setoff of collateral upon the occurrence of an event of default; (4) be conducted, together with the rights arising from the conditions required in provisions 1 and 3 above, under documentation that is legally binding on all parties and legally enforceable in each relevant jurisdiction upon the occurrence of an event of default and regardless of the counterparty's insolvency or bankruptcy; and (5) be conducted under documentation for which the bank has completed sufficient legal review to verify it meets provision 4 above and for which the bank has a well-founded legal basis for reaching this conclusion.

With regard to the counterparty VaR model that the bank uses, the bank is required to conduct regular and rigorous backtesting procedures, subject to supervisory review, to ensure the validity of the correlation factors used by the bank and the stability of these factors over time. The bank was not subject to a formal backtesting procedure requirement at the time the letter was issued. However, if supervisory review determines that the bank's counterparty VaR model or its backtesting procedures have material deficiencies and the bank does not take appropriate and expeditious steps to rectify those deficiencies, supervisors may take action to adjust the bank's capital calculations. Such action could range from imposing a multiplier on the VaR estimates of PFE calculated by the bank to disallowing the use of its counterparty VaR model and requiring use of the own estimates approach to determine the PFE component of the unsecured loan equivalent amounts.

The capital treatment that the Board approved in the letter has been and will be made available to similarly situated institutions that

request and receive Board approval for such treatment.

*Certain agency securities-lending arrangements (August 2006 exception for "securities-collateral transactions").* In response to an inquiry made by a bank, a Board interpretation was issued on August 15, 2006, which discussed the regulatory capital treatment of certain securities-lending transactions. In these transactions, the bank, acting as agent for its clients, lends its clients' securities and receives liquid securities collateral in return (the securities-collateral transactions).<sup>61</sup> Each securities loan is marked-to-market daily, and the bank calls for additional margin as needed to maintain a positive margin of collateral relative to the market value of the securities lent at all times. The bank also agrees to indemnify its clients against the risk that, in the event of borrower default, the market value of the securities collateral is insufficient to repurchase the amount of securities lent.

If the borrower were to default, the bank would be in a position to terminate a securities-collateral transaction and sell the collateral in order to purchase securities to replace the securities that were originally lent. The bank's exposure under a securities-collateral transaction would be limited to the difference between the purchase price of the replacement securities and the market value of the securities collateral.

The bank requested that the Federal Reserve Board approve another exception to the capital guidelines that would permit the bank to measure its exposure amounts for risk-based capital purposes with respect to the securities-collateral transactions under the methodology of the bank's prior May 14, 2003, approval (the prior approval). The Board, again, determined that, under its current risk-based capital guidelines, the capital charges for these securities-lending arrangements would exceed the amount of economic risk posed to the bank, which would result in capital charges that would be significantly out of proportion to the risk posed. The Board therefore approved an August 15, 2006, exception to its risk-based capital guidelines according to the prior approval, allowing the bank to compute its regulatory capital for these transactions using a loan-equivalent methodology. In so doing, the bank would assign the risk weight of the counterparty to the exposure amount of all such

61. The liquid securities collateral includes government agency, government-sponsored entity, corporate debt or equity, or asset-backed or mortgage-backed securities.

transactions with the counterparty. Specifically, the Board granted the bank its request to use an unsecured loan equivalent amount (calculated as current exposure plus a VaR-modeled PFE) for the securities-collateral transactions for risk-based capital purposes. The Board approved the exception under the reservation authority provision contained in its capital guidelines.

## Overall Assessment of Capital Adequacy

The following factors should be taken into account in assessing the overall capital adequacy of a bank.

### *Capital Ratios*

Capital ratios should be compared with regulatory minimums and with peer-group averages. Banks are expected to have a minimum total risk-based capital ratio of 8 percent. However, because risk-based capital does not take explicit account of the quality of individual asset portfolios or the range of other types of risks to which banks may be exposed, such as interest-rate, liquidity, market, or operational risks, banks are generally expected to operate with capital positions above the minimum ratios. Institutions with high or inordinate levels of risk are also expected to maintain capital well above the minimum levels.

The minimum tier 1 leverage ratio is 3 percent. However, an institution operating at or near these levels is expected to have well-diversified risk, including no undue interest-rate risk exposure, excellent asset quality, high liquidity, and good earnings, and to generally be considered a strong banking organization, rated composite 1 under the CAMELS rating system of banks. For all but the most highly rated banks meeting the above conditions, the minimum tier 1 leverage ratio is 3 percent plus an additional cushion of at least 100 to 200 basis points.

### *Impact of Management*

*Strategic planning.* One of management's most important functions is to lead the organization by designing, implementing, and supporting an effective strategic plan. Strategic planning is a long-term approach to integrating asset deploy-

ment, funding sources, capital formation, management, marketing, operations, and information systems to achieve success. Strategic planning helps the organization more effectively anticipate and adapt to change. Management must also ensure that planning information as well as corporate goals and objectives are effectively communicated throughout the organization. Effective strategic planning allows the institution to be more proactive than reactive in shaping its own future. The strategic plan should clearly outline the bank's capital base, anticipated capital expenditures, desirable capital level, and external capital sources. Each of these areas should be evaluated in consideration of the degree and type of risk that management and the board of directors are willing to accept.

*Growth.* Capital is necessary to support a bank's growth; however, it is the imposition of required capital ratios that controls growth. Because a bank has to maintain a minimum ratio of capital to assets, it will only be able to grow so fast. For example, a rapid growth in a bank's loan portfolio may be a cause of concern, for it could indicate that a bank is altering its risk profile by reducing its underwriting standards.

*Dividends.* Examiners should review historical and planned cash-dividend payout ratios to determine whether dividend payments are impairing capital adequacy.<sup>62</sup> Excessive dividend payouts may result from several sources:

- If the bank is owned by a holding company, the holding company may be requiring excessive dividend payments from the bank to fund the holding company's debt-repayment program, expansion goals, or other cash needs.
- The bank's board of directors may be under pressure from individual shareholders to provide funds to repay bank stock debt or to use for other purposes.
- Dividends may be paid or promised to support a proposed equity offering.

*Access to additional capital.* Banks that do not generate sufficient capital internally may require external sources of capital. Large, independent institutions may solicit additional funding from the capital markets. Smaller institutions may rely on a bank holding company or a principal shareholder or control group to provide addi-

62. See also "Dividends," section 4070.1.

tional funds, or on the issuance of new capital instruments to existing or new investors. Current shareholders may resist efforts to obtain additional capital by issuing new capital instruments because of the diluting effect of the new capital. In deciding whether to approve obtaining additional capital in this manner, shareholders must weigh the dilution against the possibility that, without the additional funds, the institution may fail.

Under Federal Reserve policy, a bank holding company is expected to serve as a source of strength to its subsidiary banks. A bank holding company can fulfill this obligation by having enough liquidity to inject funds into the bank or by having access to the same sources of additional capital, that is, current or existing shareholders, as outlined above.

### *Financial Considerations*

Capital levels and ratios should be evaluated in view of the bank's overall financial condition, including the following areas.

*Asset quality.* The final supervisory judgment on a bank's capital adequacy may differ significantly from conclusions that may be drawn solely from the level of a bank's risk-based capital ratio. Generally, the main reason for this difference is the evaluation of asset quality. Final supervisory judgment of a bank's capital adequacy should take into account examination findings, particularly those on the severity of problem and classified assets and investment or loan portfolio concentrations, as well as on the adequacy of the bank's allowance for loan and lease losses.

*Balance-sheet composition.* A bank whose earning assets are not diversified or whose credit culture is more risk-tolerant is generally expected to operate with higher capital levels than a similar-sized institution with well-diversified, less-risky investments.

*Earnings.* An adequately capitalized, growing bank should have a consistent pattern of capital augmentation by earnings retention. Poor earnings can have a negative effect on capital adequacy in two ways. First, any losses absorbed by capital reduce the ability of the remaining capital to fulfill that function. Second, the impact of losses on capital is magnified by the fact that

a bank generating losses is incapable of replenishing its capital accounts internally.

*Funds management.* A bank with undue levels of interest-rate risk should be required to strengthen its capital positions, even though it may meet the minimum risk-based capital standards. Assessments of capital adequacy should reflect banks' appropriate use of hedging instruments. Other things being equal, banks that have appropriately hedged their interest-rate exposure will be permitted to operate with lower levels of capital than those banks that are vulnerable to interest-rate changes. While the Federal Reserve does not want to discourage the use of legitimate hedging vehicles, some instruments, in particular interest-only strips (IOs) and principal-only strips (POs), raise concerns. IOs and POs have highly volatile price characteristics as interest rates change, and they are generally not considered appropriate investments for most banks. However, some sophisticated banks may have the expertise and systems to appropriately use IOs and POs as hedging vehicles.

*Off-balance-sheet items and activities.* Once funded, off-balance-sheet items become subject to the same capital requirements as on-balance-sheet items. A bank's capital levels should be sufficient to support the quality and quantity of assets that would result from a significant portion of these items being funded within a short time.

### *Adequacy of and Compliance with Capital-Improvement Plans*

Capital-improvement plans are required for banks operating with capital ratios below regulatory minimums as required by the prompt-corrective-action part of the Federal Deposit Insurance Act, as well as for some banks operating under supervisory actions. Examiners should review any such plans and determine their adequacy and reasonableness, keeping in mind that banks may meet required capital-to-asset ratios in three ways:

- They may issue more capital. In doing so, banks must weigh the need for additional capital against the dilution of market value that will result.
- They may retain earnings rather than paying them out as dividends.



- They may sell assets. By reducing the amount of total assets, a bank reduces the amount of capital necessary to meet the required ratios.

### *Inadequate Allowance for Loan and Lease Losses*

An inadequate allowance for loan and lease losses (ALLL) will require an additional charge to current income. Any charge to current income will reduce the amount of earnings available to supplement tier 1 capital. Because the amount of the ALLL that can be included in tier 2 capital is limited to 1.25 percent of gross risk-weighted assets, an additional provision may increase the ALLL level above this limit, thereby resulting in the excess portion being excluded from tier 2 capital.

### *Ineligible Collateral and Guarantees*

The risk-based capital guidelines recognize only limited types of collateral and guarantees. Other types of collateral and guarantees may support the asset mix of the bank, particularly within its loan portfolio. Such collateral or guarantees may serve to substantially improve the overall quality of a loan portfolio and other credit exposures, and should be considered in the overall assessment of capital adequacy.

### *Market Value of Bank Stock*

Examiners should review trends in the market price of the bank's stock and whether stock is trading at a reasonable multiple of earnings or a reasonable percentage (or multiple) of book value. A bank's low stock price may merely be an indication that it is undervalued, or it may be indicative of regional or industry-wide problems. However, a low-valued stock may also indicate that investors lack confidence in the institution; such lack of support could impair the bank's ability to raise additional capital in the capital markets.

### *Subordinated Debt in Excess of Limits*

The total of term subordinated debt and intermediate-term preferred stock that may be

included in tier 2 capital is limited to 50 percent of tier 1 capital. Amounts issued or outstanding in excess of this limit are not included in the risk-based capital calculation but should be taken into consideration when assessing the bank's funding and financial condition.

### *Unrealized Asset Values*

Banks often have assets on their books that are carried at significant discounts below current market values. The excess of the market value over the book value (historical cost or acquisition value) of assets such as investment securities or banking premises may represent capital to the bank. These unrealized asset values are not included in the risk-based capital calculation but should be taken into consideration when assessing capital adequacy. Particular attention should be given to the nature of the asset, the reasonableness of its valuation, its marketability, and the likelihood of its sale.

### *Accounting for Defined Benefit Pension and Other Postretirement Plans*

In September 2006, the Financial Accounting Standards Board adopted the Statement of Financial Accounting Standard No. 158, "Employers Accounting for Defined Benefit Pension and Other Postretirement Plans" (FAS 158). The standard requires, as early as December 31, 2006, that a bank, bank holding company, or other banking or thrift organization that sponsors a single-employer defined benefit postretirement plan—such as a pension plan or health care plan—to recognize the overfunded or underfunded status of each such plan as an asset or liability on its balance sheet with corresponding adjustments recognized in accumulated other comprehensive income (AOCI), a component of equity capital. After a banking organization initially applies FAS 158, changes in the benefit plan asset or liability reported on the organization's balance sheet will be recognized in the year in which the changes occur and will result in an increase or decrease in AOCI. Postretirement plan amounts carried in AOCI are adjusted as they are subsequently recognized in earnings as components of the plans' net periodic benefit cost.

The Federal Reserve Board, along with other federal bank and thrift regulatory agencies (the



Agencies<sup>63</sup>), issued a joint press release on December 14, 2006, in which they announced that FAS 158 will not affect a banking organizations' regulatory capital. The agencies decided, until they can determine otherwise through a rulemaking, that banks should exclude from regulatory capital any amounts recorded in AOCI resulting from the adoption and application of FAS 158. The purpose of this exclusion is to neutralize the effect of the application of FAS 158 on regulatory capital, including the reporting of the risk-based and leverage capital measures.

## TIER 1 LEVERAGE RATIO FOR STATE MEMBER BANKS

The Federal Reserve has adopted a minimum ratio of tier 1 capital to average total assets to assist in the assessment of the capital adequacy of state member banks. The principal objective of this measure (which is intended to be used as a supplement to the risk-based capital measure) is to place a constraint on the maximum degree to which a state member bank can leverage its equity capital base.

The guidelines implementing the tier 1 leverage ratio are found in Regulation H (12 CFR 208), appendix B, and apply to all state member banks on a consolidated basis. The ratio is to be used in the examination and supervisory process, as well as in the analysis of applications acted on by the Federal Reserve.

A bank's tier 1 leverage ratio is calculated by dividing its tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). For purposes of calculating this ratio during an examination, examiners may use the bank's average total assets as of the last Call Report date. The ratio will be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of tier 1 capital as set forth in the risk-based capital guidelines in appendix A of the Federal Reserve's Regulation H is used. Average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the bank's Reports of Condition and Income (Call Reports), less good-

will; amounts of mortgage-servicing assets, nonmortgage-servicing assets, and purchased credit-card relationships that, in the aggregate, are in excess of 100 percent of tier 1 capital; amounts of nonmortgage-servicing assets and purchased credit-card relationships that, in the aggregate, are in excess of 25 percent of tier 1 capital; amounts of credit-enhancing interest-only strips that are in excess of 25 percent of tier 1 capital; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from tier 1 capital; deferred tax assets that are dependent on future taxable income, net of their valuation allowance, in excess of the limitations set forth in section II.B. of appendix A of Regulation H; and the amount of the total adjusted carrying value of nonfinancial equity investments that is subject to a deduction from tier 1 capital.

Under the tier 1 leverage ratio guidelines, the minimum level of tier 1 capital to total assets for strong state member banks is 4 percent, unless they are rated composite 1 under the UFIRS (CAMELS) rating system of banks. Institutions not meeting these characteristics, as well as institutions with supervisory, financial, or operational weaknesses, are expected to operate well above minimum capital standards. Institutions experiencing or anticipating significant growth are also expected to maintain capital ratios, including tangible capital positions, well above the minimum levels. Moreover, higher capital ratios may be required for any banking institution if warranted by its particular circumstances or risk profile. In all cases, institutions should hold capital commensurate with the level and nature of the risks, including the volume and severity of problem loans, to which they are exposed.

A bank that does not have a 4 percent leverage ratio (3 percent if it is rated a composite CAMELS 1) is considered undercapitalized under the prompt-corrective-action framework and must file a capital-restoration plan that meets certain requirements.

## De Novo Banks

Initial capital in a de novo state member bank should be reasonable in relation to the bank's location, business plan, competitive environment, and state law. At a minimum, however, a

63. The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

de novo bank must maintain a tangible tier 1 leverage ratio (core capital elements minus all intangible assets divided by average total assets minus all intangible assets) of 9 percent for the first three years of operations. The applicant must provide projections of asset growth and earnings performance that reasonably support the bank's ability to maintain this ratio without

reliance on additional capital injections. Even though a 9 percent tangible leverage ratio is not required after the third year, de novo banks are expected to maintain capital ratios that are commensurate with ongoing safety-and-soundness concerns and that are generally well in excess of regulatory minimums. (See SR-91-17.)

# Assessment of Capital Adequacy

## Examination Objectives

Effective date May 2000

## Section 3020.2

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1. To determine the adequacy of capital.
2. To determine compliance with the risk-based and tier 1 leverage capital adequacy guidelines.
3. To determine if the policies, practices, and procedures with regard to the capital adequacy guidelines are adequate.
4. To determine if the bank's officers and employees are operating in conformity with the Board's established capital adequacy guidelines.
5. To evaluate the propriety and consistency of the bank's present and planned level of capitalization in light of the risk-based and leverage capital guidelines, as well as existing conditions and future plans.
6. To initiate corrective action when policies, procedures, or capital are deficient.
7. To evaluate whether—
  - a. the institution is fully capable of assessing the credit risk associated with the collateralized loan obligations (CLOs) it retains in its banking book (nontrading accounts); and
  - b. the institution is adequately capitalized given its residual risk exposure involving CLOs.

### VERIFICATION OF THE RISK-BASED CAPITAL RATIO

Examiners should verify that the bank has adequate systems in place to compute and document its risk-based capital ratios. Small banks with capital ratios well in excess of established minimums may not have a system explicitly designed to capture risk-based capital information. In addition, depending on a bank's current capital structure and ratios, all procedures may not apply.

1. Verify that the bank is correctly reporting the risk-based capital information requested on the Reports of Condition and Income.

For the qualifying components of capital (the ratio's numerator):

2. Determine if management is adhering to the underlying terms of any currently outstanding stock issues.
3. Review common stock to ensure that the bank is in compliance with the terms of any underlying agreements and to determine if more than one class exists. When more than one class exists, review the terms for any preference or nonvoting features. If the terms include such features, determine whether the class of common stock qualifies for inclusion in tier 1 capital.
4. Review any perpetual and long-term preferred stock for the following:
  - a. Compliance with terms of the underlying agreements carefully noting—
    - adherence to the cumulative or noncumulative nature of the stock and
    - adherence to any conversion rights.
  - b. Proper categorization as tier 1 or tier 2 for capital adequacy purposes, noting the following requirements:
    - Tier 1 perpetual preferred stock must have the following characteristics:
      - no maturity date
      - cannot be redeemed at the option of the holder
      - unsecured
      - ability to absorb losses
      - ability and legal right for issuer to defer or eliminate dividends

- any issuer-redemption feature must be subject to prior Federal Reserve approval
  - noncumulative
  - fixed rate or traditional floating or adjustable rate
  - must not contain features that would require or create an incentive for the issuer to redeem or repurchase the instrument, such as an “exploding rate,” an auction-rate pricing mechanism, or a feature that allows the stock to be converted into increasing numbers of common shares
- Perpetual preferred stock, includable within tier 2 capital without a sublimit, must have the characteristics listed above for tier 1 perpetual preferred stock, but perpetual preferred stock does not otherwise qualify for inclusion in tier 1 capital. For example, cumulative or auction-rate perpetual preferred stock, which does not qualify for tier 1 capital, may be includable in tier 2 capital.
5. Verify that minority interest in equity accounts of consolidated subsidiaries included in tier 1 capital consists only of qualifying tier 1 capital elements. Determine whether any perpetual preferred stock of a subsidiary that is included in minority interest is secured by the subsidiary's assets; if so, that stock may not be included in capital.
  6. Review the intermediate-term preferred stock and subordinated debt instruments included in capital for the following:
    - a. Compliance with terms of the underlying agreements, noting that subordinated debt containing the following terms may not be included in capital:
      - interest payments tied to the bank's financial condition
      - acceleration clauses or broad conditions of events of default that are inconsistent with safe and sound banking practices
    - b. Compliance with restrictions on the inclusion of such instruments in capital by verifying that the aggregate amount

of both types of instruments does not exceed 50 percent of tier 1 capital (net of goodwill) and that the portions includable in tier 2 capital possess the following characteristics:

- unsecured
  - minimum five-year original weighted average maturity
  - in the case of subordinated debt, contains terms stating that the debt (1) is not a deposit, (2) is not insured by a federal agency, (3) cannot be redeemed without prior approval from the Federal Reserve, and (4) is subordinated to depositors and general creditors
- c. Appropriate amortization, if the instruments have a remaining maturity of less than five years.
7. Determine, through review of minutes of board of directors meetings, if a stock offering or subordinated debt issue is being considered. If so, determine that management is aware of the risk-based capital requirements for inclusion in capital.
8. Review any mandatory convertible debt securities for the following:
- a. Compliance of the terms with the criteria set forth in 12 CFR 225 (Regulation Y), appendix B.
  - b. Notification in the terms of agreement that the redemption or repurchase of such securities before maturity is subject to prior approval from the Federal Reserve.
  - c. The treatment of the portions of such securities covered by the issuance of common or perpetual preferred stock dedicated to the repayment of the securities, bearing in mind the following:
    - The amount of the security covered by dedicated stock should be treated as subordinated debt and is subject, together with other subordinated debt and intermediate-term preferred stock, to a sublimit within tier 2 capital of 50 percent of tier 1 capital, as well as to amortization in the last five years of life.
    - The portion of a mandatory convertible security that is not covered by dedication qualifies for inclusion in tier 2 capital without any sublimit and without being subject to amortization in the last five years of life.
9. Verify that the amount of the allowance for loan and lease losses included in tier 2 capital has been properly calculated and disclosed, and verify that the supporting computations of that amount have been adequately documented.
- For the calculation of risk-weighted assets (the ratio's denominator):
10. Determine whether the bank consolidates, in accordance with the Financial Accounting Standards Board's FIN 46-R, the assets of any asset-backed commercial paper (ABCP) program that it sponsors.
- a. Determine whether the bank's ABCP program meets the definition of a *sponsored ABCP program* under the Federal Reserve's risk-based capital guidelines. If the bank does consolidate the assets of an ABCP program, review the documentation of its risk-based capital ratio calculations, and determine whether the associated ABCP program's assets and minority interests were excluded from the bank's risk-weighted asset base (and also if they were excluded from tier 1 capital—the ratio's numerator). See section III.B.6. of the risk-based capital guidelines (12 CFR 208, appendix A).
  - b. Determine whether any of the bank's liquidity facilities meet the definition and requirements of an *eligible ABCP liquidity facility* under the Federal Reserve's risk-based capital guidelines. See section III.B.3.a.iv. of the risk-based capital guidelines (12 CFR 208, appendix A).
  - c. Determine from the bank's supporting documentation of its risk-based capital ratios whether the bank held risk-based capital against its eligible ABCP liquidity facilities.
  - d. Determine whether the bank applied the correct conversion factors to the eligible ABCP liquidity facilities when it determined the amount of risk-weighted assets for its risk-based capital ratios. See section III.D. of the risk-based capital guidelines (12 CFR 208, appendix A).
    - For those eligible ABCP liquidity facilities having an original maturity of one year or less, determine if a 10 percent credit-conversion factor was used.
    - For those eligible ABCP liquidity facilities having an original maturity

- exceeding one year, determine if a 50 percent credit-conversion factor should have been used.
- e. Determine if ineligible ABCP liquidity facilities were treated as direct-credit substitutes or as recourse obligations, as required by the risk-based capital guidelines.
11. Verify that each on- and off-balance-sheet item has been assigned to the appropriate risk category in accordance with the risk-based capital guidelines. Close attention should be paid to the underlying obligor, collateral, and guarantees, and to assignment to a risk category based on the terms of a claim. The claim should be assigned to the risk category appropriate to the highest risk option available under the terms of the transaction. Verify that the bank's documentation supports the assignment of preferential risk weights. If necessary, recalculate the value of risk-weighted assets.
  12. Verify that all off-balance-sheet items have been converted properly to credit-equivalent amounts based on the risk-based capital guidelines. Close attention should be paid to the proper reporting of assets sold with recourse, financial and performance standby letters of credit, participations of off-balance-sheet transactions, and commitments.

## VERIFICATION OF THE TIER 1 LEVERAGE RATIO

1. Verify that the bank has correctly calculated tier 1 capital in accordance with the definition of tier 1 capital, as set forth in the risk-based capital guidelines.
2. Verify that the bank has properly calculated average total consolidated assets, which are defined as the quarterly average total assets as reported on the Call Report, less goodwill and any other intangible assets and any investments in subsidiaries that the Federal Reserve determines should be deducted from tier 1 capital.

## OVERALL ASSESSMENT OF CAPITAL ADEQUACY

1. For banks that do not meet the minimum risk-based tier 1 leverage capital standards or that are otherwise considered to lack sufficient capital to support their activities, examine the bank's capital plans for achieving adequate levels of capital. In conjunction with management of the appropriate Reserve Bank, determine whether the plans are acceptable to the Federal Reserve. Review and comment on these plans and any progress achieved in meeting the requirements.
2. The review processes discussed in "Overall Conclusions Regarding Condition of the Bank," section 5020.1, require an evaluation of the propriety and consistency of the bank's present and planned level of capitalization in light of existing conditions and future plans. In this regard, the examiner assigned to assessing capital adequacy should do the following:
  - a. Using the latest Uniform Bank Performance Report (UBPR), analyze applicable ratios involving capital funds, comparing these ratios with those of the bank's peer group and investigating trends or significant variations from peer-group averages.
  - b. Determine, with regard to the bank's overall financial condition, that the bank's capital is sufficient to compensate for any instabilities or deficiencies in the asset and liability mix and in quality, as described in the "Funds Management" paragraph ("Financial Considerations" subsection of section 3020.1).
  - c. Determine if the bank's earnings performance enables it to fund its expansion adequately, to remain competitive in the market, and to replenish or increase its capital funds as needed.
  - d. Analyze trends in the bank's deposit and borrowed funds structure to determine whether capital is maintained at a level sufficient to sustain depositor and lender confidence.
  - e. If the allowance for loan and lease losses is determined to be inadequate, analyze the impact of current and potential losses on the bank's capital structure. See "Analytical Review and Income and Expense," section 4010.1.
  - f. Consider the impact of any management deficiencies on present and projected capital.
  - g. Determine if there are any assets or contingent accounts whose quality rep-

- resents an actual or potential serious weakening of capital.
- h. Consider the potential impact of any proposed changes in controlling ownership (if approved) on the projected capital position.
  - i. Analyze assets that are considered undervalued on the balance sheet and carried at below-market values. The excess of fair value over cost may represent an additional cushion to the bank.
  - j. Consider the cushion for absorbing losses that may be provided by any subordinated debt or intermediate-term preferred stock not included in tier 2 capital because of the 50 percent of tier 2 capital limitation, or that is not included in capital for tier 1 leverage ratio purposes.
  - k. Analyze any collateral and guarantees supporting assets that may not be taken into account for risk-based or tier 1 leverage capital purposes, and consider these collateral and guarantees in the overall assessment of capital adequacy.
  - l. Evaluate the bank's overall asset quality, and determine whether the bank needs to strengthen its capital position based on the following:
    - the severity of problem and classified assets
    - investment or loan-portfolio concentrations
    - the adequacy of loan-loss reserves
  - m. Analyze the bank's interest-rate risk and use of hedging instruments. Determine if the bank should strengthen its capital position because of undue levels of risk. Review hedging instruments for the use of interest-only strips (IOs) and principal-only strips (POs) (which raise concerns), and review management's expertise in using hedging instruments.
  - n. Determine whether the sponsoring bank is able to assess and manage the retained risk in its credit portfolio after the issuance of synthetic collateralized loan obligations (CLOs).
  - o. If the bank has used the special risk-based regulatory capital treatment for synthetic CLOs, verify that the stringent minimum conditions have been met for that treatment.
3. Review capital adjustments such as goodwill and intangible assets by performing the following procedures:
    - a. Verify the existence of adequate documentation concerning book and fair values and the amortization method.
    - b. Verify that intangibles are being reduced in accordance with the amortization method. If the book carrying amount exceeds the fair value, the intangible should be written down or off.
    - c. Determine if the bank is performing a quarterly review of the book and fair values and the quality of all intangibles.
    - d. Verify that goodwill and other nonqualifying identifiable intangibles are deducted from tier 1 capital.
    - e. Determine the proper inclusion of other identifiable intangibles included in tier 1 capital by verifying that the criteria and limitations outlined in the risk-based capital guidelines are met.
  4. In light of the analysis conducted in step 2 (under "Overall Assessment of Capital Adequacy"), and in accordance with the Federal Reserve's capital adequacy guidelines, determine any appropriate supervisory action with regard to the bank's capital adequacy.
  5. Review the following items with the examiner-in-charge in preparation for discussion with appropriate management:
    - a. all deficiencies noted with respect to the capital accounts
    - b. the adequacy of present and projected capital
  6. Ascertain through minutes, reports, etc., or through discussions with management, how the future plans of the bank (for example, growth through commercial lending, retail operations, etc.) will affect the bank's asset quality, capital position, and other areas of its balance sheet.
  7. Prepare comments for the examination report on the bank's capital position, including any deficiencies noted.
  8. Update the workpapers with any information that will facilitate future examinations.

# Assessment of Capital Adequacy Internal Control Questionnaire

Effective date November 1993

Section 3020.4

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

## GENERAL

1. Has the bank established procedures to ensure that—
  - a. all components of capital are accurately categorized and reported for purposes of the risk-based and leverage capital measures?
  - b. all on-and off-balance-sheet items are accurately risk-weighted and reported for purposes of the risk-based capital measures?
  - c. categorization of on- and off-balance-sheet items and capital for purposes of the risk-based capital measures is adequately documented?
  - d. the bank is in compliance with the terms of any contractual agreements underlying capital instruments?
  - e. management and the board of directors consider the requirements of the risk-based capital guidelines for inclusion in capital of stock or debt prior to issuance?
2. Does the bank prepare a periodic analysis of its risk-based and leverage capital positions to assess capital adequacy for both current and anticipated needs?
- \*3. Has the board of directors authorized specific bank officers to—
  - a. sign stock certificates?
  - b. maintain custody of unissued stock certificates?
  - c. maintain stock journals and records?
- \*4. Are capital transactions verified by more than one person before stock certificates are issued?
- \*5. Are stock certificates and debentures handled by persons who do not also record those transactions?
- \*6. Does the bank maintain a stock certificate book with certificates serially numbered by the printer?
- \*7. Is the stock certificate book maintained under dual control?
- \*8. Does the bank's policy prohibit the signing of blank stock certificates?
- \*9. Does the bank maintain a shareholders' ledger that shows the total number of shares owned by each stockholder?
- \*10. Does the bank maintain a stock transfer journal disclosing names, dates, and amounts of transactions?
- \*11. Does the bank cancel surrendered stock certificates?
- \*12. Are inventories of unissued notes or debentures—
  - a. maintained under dual control?
  - b. counted periodically by someone other than the person responsible for their custody?
- \*13. When transfers are made—
  - a. are notes or debentures surrendered and promptly cancelled?
  - b. are surrendered notes or debentures inspected to determine that proper assignment has been made and that new notes or debentures agree in amount?

## CONCLUSION

14. Indicate additional procedures used in arriving at conclusions.
15. Are internal controls of capital adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?



# Assessing Risk-Based Capital—Direct-Credit Substitutes Extended to ABCP Programs

Effective date October 2007

## Section 3030.1

The Federal Reserve Board and the other federal banking agencies (the agencies)<sup>1</sup> amended their risk-based capital standards on November 29, 2001, to adopt a new capital framework for banking organizations (includes bank holding companies) engaged in securitization activities (the securitization capital rule).<sup>2</sup> In March 2005, the agencies issued interagency guidance that clarifies how banking organizations are to use internal ratings that they assign to asset pools purchased by their asset-backed commercial paper (ABCP) programs in order to appropriately risk-weight any direct-credit substitutes (for example, guarantees) extended to such programs. For state member bank examination purposes, the interagency guidance has been reformatted for examiner use as examination objectives, examination procedures, and an internal control questionnaire. The guidance uses the term “banking organization.” In this section, the guidance should be interpreted to mean the application of the risk-based capital guidelines to all state member banks on a consolidated basis.

The guidance sets forth an analytical framework for assessing the broad risk characteristics of direct-credit substitutes<sup>3</sup> that a banking organization provides to an ABCP program it sponsors. The guidance provides specific information on evaluating direct-credit substitutes issued in the form of program-wide credit enhancements, as well as an approach to determine the risk-based capital charge for these enhancements. (See SR-05-6 and its attachment. Also, see sections 3020.1, “Assessment of Capital Adequacy,” and 4030.1, “Asset Securitization.”)

The securitization capital rule permits banking organizations with qualifying internal risk-rating systems to use those systems to apply the

internal-ratings approach to their unrated direct-credit substitutes extended to ABCP programs<sup>4</sup> that they sponsor by mapping internal risk ratings to external rating equivalents. These external credit rating equivalents are organized into three ratings categories: investment-grade (BBB and above) credit risk, high non-investment-grade (BB+ through BB-) credit risk, and low non-investment-grade (below BB-) credit risk. These rating categories can then be used to determine whether a direct-credit substitute provided to an ABCP program should be (1) assigned to a risk weight of 100 percent or 200 percent or (2) subject to the “gross-up” treatment, as summarized in the table on the next page.<sup>5</sup> (See appendix A for a more detailed description of ABCP programs.)

As the table indicates, the minimum risk weight available under the internal risk-ratings approach is 100 percent, regardless of the internal rating.<sup>6</sup> Conversely, positions rated below BB- receive the gross-up treatment. That is, the banking organization holding the position must maintain capital against the amount of the position plus all more senior positions.<sup>7</sup> Application of gross-up treatment, in many cases, will result in a full dollar-for-dollar capital charge (the equivalent of a 1,250 percent risk weight) on direct-credit substitutes that fall into the low non-investment-grade category. In addition, the risk-based capital requirement applied to a direct-credit substitute is subject to the low-level-exposure rule. Under the rule, the amount of required risk-based capital would be limited to the lower of a full dollar-for-dollar capital charge against the direct-credit substitute or the effective risk-based capital charge (for example, 8 percent) for the entire amount of assets in the

1. The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

2. See 66 *Fed. Reg.* 59614 (November 29, 2001). See also 12 C.F.R. 208, appendix A, section III.B.3.

3. *Direct-credit substitute* means an arrangement in which a banking organization assumes, in form or in substance, credit risk associated with an on- or off-balance-sheet credit exposure that it did not previously own (that is, a third-party asset) and the risk it assumes exceeds the pro rata share of its interest in the third-party asset. If the banking organization has no claim on the third-party asset, then the organization’s assumption of any credit risk with respect to the third-party asset is a direct-credit substitute.

4. ABCP programs include multiseller ABCP conduits, credit arbitrage ABCP conduits, and structured investment vehicles.

5. The rating designations (for example, “BBB-” and “BB+”) used in the table are illustrative only and do not indicate any preference for, or endorsement of, any particular rating designation system.

6. Exposures externally rated by a nationally recognized statistical rating organization (NRSRO) above BBB+ are eligible for lower risk weights (that is, 20 percent for AAA and AA, 50 percent for A).

7. *Gross-up treatment* means that a position is combined with all more senior positions in the transaction. The resulting amount is then risk-weighted based on the obligor or, if relevant, the guarantor or the nature of the collateral.

<i>Internal risk-rating equivalent</i>	<i>Ratings category</i>	<i>Risk weighting</i>
BBB- or better	Investment grade	100%
BB+ to BB-	High non-investment grade	200%
Below BB-	Low non-investment grade	Gross-up treatment

ABCP program.<sup>8</sup>

The use of internal risk ratings under the securitization capital rule is limited to determining the risk-based capital charge for unrated direct-credit substitutes that banking organizations provide to ABCP programs. Thus, banking organizations may not use the internal-ratings approach to derive the risk-based capital requirement for unrated direct-credit substitutes extended to other transactions. Approved use of the internal rating-based approach for ABCP programs under the securitization capital rule will have no bearing on the overall appropriateness of a banking organization's internal risk-rating system for other purposes.

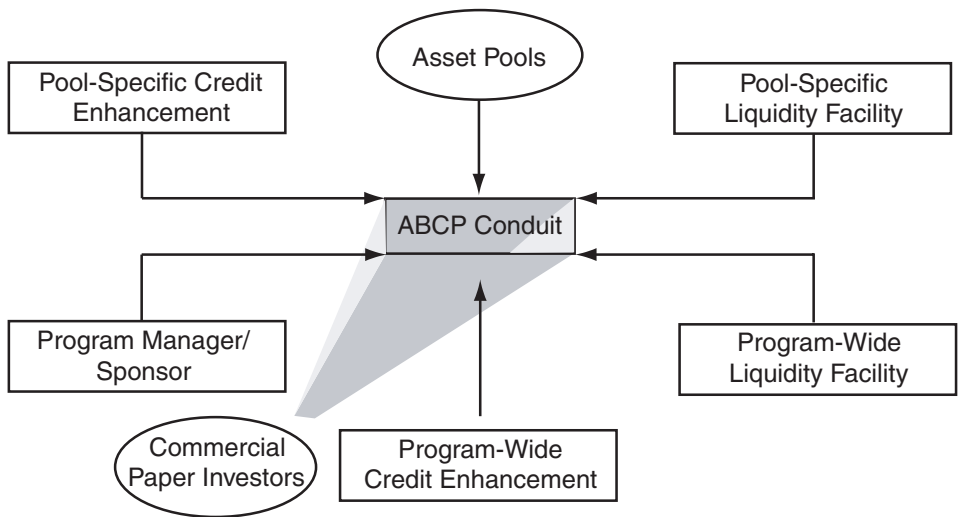
Most rated commercial paper issued out of an ABCP program is supported by program-wide credit enhancement, which is a direct-credit substitute. Often the sponsoring banking organization provides, in whole or in part, program-wide credit enhancement to the ABCP program. Program-wide credit enhancement may take a number of different forms, including an irrevocable loan facility, a standby letter of credit, a financial guarantee, or a subordinated debt.

The interagency guidance also discusses the weakest-link approach. This approach is used for calculating the risk-based capital requirement and assumes that the risk of the program-wide credit enhancement is directly dependent on the quality (that is, internal rating) of the riskiest transaction(s) within the ABCP program. (See step 9 of the examination procedures, section 3030.3.) More specifically, the weakest-link concept presupposes the probability that the program-wide credit enhancement that will be drawn is equal to the probability of default of the transaction(s) with the weakest transaction risk rating.

A process is provided that is designed to aid in determining the regulatory capital treatment for program-wide credit enhancements, provided to an ABCP program. The *key underlying principles* are as follows:

1. The determination of the credit quality of the program-wide credit enhancement shall be based on the risk of draw and subsequent loss, which depends directly on the quality of the credit-enhanced assets funded through the ABCP program.
2. An estimate of the risk of draw for the program-wide credit enhancement is derived from the quality (rating) of the riskiest credit(s) within the ABCP program, which is often indicated by the internal rating a banking organization assigns to a transaction's pool-specific liquidity facility. Other credit risks (for example, seller/servicer risk) to the program-wide credit enhancement may also be considered.
3. The weakest-link approach assigns risk-based capital against the program-wide credit enhancement in rank order of the internal ratings starting with the lowest-rated positions supported by the program-wide credit enhancement. Therefore, if all of the positions supported by the program-wide credit enhancement are internally rated investment grade, the banking organization would risk-weight the notional amount of the program-wide credit enhancement at 100 percent and there would be no need to proceed further. However, for positions supported by the program-wide credit enhancement that are non-investment grade, banking organizations can use the formula-driven weakest-link approach illustrated in step 9 of the examination procedures to generate the appropriate amount of risk-based capital to be assessed against an unrated position.

8. The low-level-exposure rule provides that the dollar amount of risk-based capital required for a recourse obligation or direct-credit substitute should not exceed the maximum dollar amount for which a banking organization is contractually liable. (See 12 C.F.R. 208, appendix A, section III.B.3.g.i.)



## ASSESSMENT OF INTERNAL RATING SYSTEMS

The guidance is organized in the form of a decision tree that (1) provides an outline of the key decisions that examiners and sponsoring banking organizations should consider when reviewing internal risk-rating systems for ABCP programs and (2) provides supervisors with more-specific information on how to assess the adequacy of these systems. Many of the qualitative and quantitative factors used to evaluate risk in this guidance are comparable with rating agency criteria (for example, criteria from S&P, Moody's, and Fitch) because the ABCP program sponsors generally use the rating methodologies of nationally recognized statistical rating organizations (NRSROs) when assessing the credit quality of their risk exposures to ABCP programs. The guidance has two primary goals:

- provide information to banking organizations to ensure the accuracy and consistency of the ratings assigned to transactions in an ABCP program
- assist supervisors in assessing the adequacy of a banking organization's internal risk-rating system based on the nine key criteria set forth in the securitization capital rule<sup>9</sup>

9. 12 C.F.R. 208, appendix A, III.B.3.f.i.

## APPENDIX A—OVERVIEW OF ABCP PROGRAMS

ABCP programs provide a means for corporations to obtain relatively low-cost funding by selling or securitizing pools of homogenous assets (for example, trade receivables) to special-purpose entities (SPEs/ABCP programs). The ABCP program raises funds for purchase of these assets by issuing commercial paper into the marketplace. The commercial paper investors are protected by structural enhancements provided by the seller (for example, overcollateralization, spread accounts, early-amortization triggers, etc.) and by credit enhancements (for example, subordinated loans or guarantees) provided by banking organization sponsors of the ABCP program and by other third parties. In addition, liquidity facilities are also present to ensure the rapid and orderly repayment of commercial paper should cash-flow difficulties emerge. ABCP programs are nominally capitalized SPEs that issue commercial paper. A sponsoring banking organization establishes the ABCP program but usually does not own the conduit's equity, which is often held by unaffiliated third-party management companies that specialize in owning such entities, and are structured to be bankruptcy remote.

## Typical Structure

ABCP programs are funding vehicles that banking organizations and other intermediaries establish to provide an alternative source of funding to themselves or their customers. In contrast to term securitizations, which tend to be amortizing, ABCP programs are ongoing entities that usually issue new commercial paper to repay maturing commercial paper. The majority of ABCP programs in the capital markets are established and managed by major international commercial banking organizations. As with traditional commercial paper, which has a maximum maturity of 270 days, ABCP is short-term debt that may either pay interest or be issued at a discount.

## Types of ABCP Programs

Multiseller programs generally provide working capital financing by purchasing or advancing against receivables generated by multiple corporate clients of the sponsoring banking organizations. These programs are generally well diversified across both sellers and asset types.

*Single-seller programs* are generally established to fund one or more types of assets originated by a single seller. The lack of diversification is generally compensated for by increased program-wide credit enhancement.

*Loan-backed programs* fund direct loans to corporate customers of the ABCP program's sponsoring banking organization. These loans are generally closely managed by the banking organization and have a variety of covenants designed to reduce credit risk.

*Securities-arbitrage programs* invest in securities that generally are rated AA- or higher. They generally have no additional credit enhancement at the seller/transaction level because the securities are highly rated. These programs are typically well diversified across security types. The arbitrage is mainly due to the difference between the yield on the securities and the funding cost of the commercial paper.

*Structured investment vehicles (SIVs)* are a form of a securities-arbitrage program. These ABCP programs invest in securities typically rated AA-

or higher. SIVs operate on a market-value basis similar to market value CDOs in that they must maintain a dynamic overcollateralization ratio determined by analysis of the potential price volatility on securities held in the portfolio. SIVs are monitored daily and must meet strict liquidity, capitalization, leverage, and concentration guidelines established by the rating agencies.

## Key Parties and Roles

Key parties for an ABCP program include the following:

- program management/administrators
- credit-enhancement providers
- liquidity-facility providers
- seller/servicers
- commercial paper investors

### *Program Management*

The sponsor of an ABCP program initiates the creation of the program but typically does not own the equity of the ABCP program, which is provided by unaffiliated third-party investors. Despite not owning the equity of the ABCP program, sponsors usually retain a financial stake in the program by providing credit enhancement, liquidity support, or both, and they play an active role in managing the program. Sponsors typically earn fees—such as credit-enhancement, liquidity-facility, and program-management fees—for services provided to their ABCP programs.

Typically, an ABCP program makes arrangements with various agents/servicers to conduct the administration and daily operation of the ABCP program. This includes such activities as purchasing and selling assets, maintaining operating accounts, and monitoring the ongoing performance of each transaction. The sponsor is also actively engaged in the management of the ABCP program, including underwriting the assets purchased by the ABCP program and the type/level of credit enhancements provided to the ABCP program.

### *Credit-Enhancement Providers*

The sponsoring banking organization typically provides pool-specific and program-wide backup

liquidity facilities, and program-wide credit enhancements, all of which are usually unrated (pool-specific credit enhancement, such as overcollateralization, is provided by the seller of the assets). These enhancements are fundamental for obtaining high investment-grade ratings on the commercial paper issued to the market by the ABCP program. Seller-provided credit enhancement may exist in various forms and is generally sized based on the type and credit quality of the underlying assets as well as the quality and financial strength of seller/servicers. Higher-quality assets may only need partial support to achieve a satisfactory rating for the commercial paper. Lower-quality assets may need full support.

### *Liquidity-Facility Providers*

The sponsoring banking organization and in some cases, unaffiliated third parties, provide pool-specific or program-wide liquidity facilities. These backup liquidity facilities ensure the timely repayment of commercial paper under certain conditions, such as financial market disruptions or if cash-flow timing mismatches occur, but generally not under conditions associated with the credit deterioration of the underlying assets or the seller/servicer to the extent that such deterioration is beyond what is permitted under the related asset-quality test.

### *Commercial Paper Investors*

Commercial paper investors are typically institutional investors, such as pension funds, money market mutual funds, bank trust departments, foreign banks, and investment companies. Commercial paper maturities range from 1 day to 270 days, but most frequently are issued for 30 days or less. There is a limited secondary market for commercial paper since issuers can closely match the maturity of the paper to the investors' needs. Commercial paper investors are generally repaid from the reissuance of new commercial paper or from cash flows stemming from the underlying asset pools purchased by the program. In addition, to ensure timely repayment in the event that new commercial paper cannot be issued or if anticipated cash flows from the underlying assets do not occur, ABCP programs utilize backup liquidity facilities. In addition, the banking organization

can purchase the ABCP from the conduit if the commercial paper cannot be issued. Pool-specific and program-wide credit enhancements also protect commercial paper investors from deterioration of the underlying asset pools.

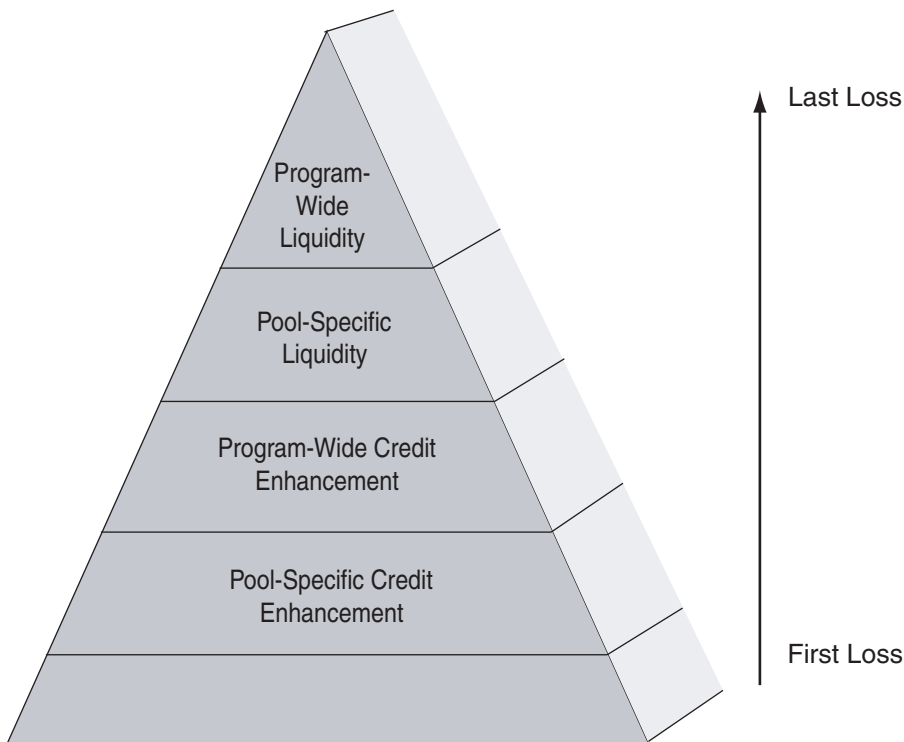
### *The Loss Waterfall*

The loss waterfall diagram (on the next page) for the exposures of a typical ABCP program generally has four legally distinct layers. However, most legal documents do not specify which form of credit or liquidity enhancement is in a priority position after pool-specific credit enhancement is exhausted due to defaults. For example, after becoming aware of weakness in the seller/servicer or in asset performance, an ABCP program sponsor may purchase assets out of the conduit using pool-specific liquidity. Liquidity agreements must be subject to a valid asset-quality test that prevents the purchase of defaulted or highly delinquent assets. Liquidity facilities that are not limited by such an asset-quality test are to be viewed as credit enhancement and are subject to the risk-based capital requirements applicable to direct-credit substitutes.

### *Pool-Specific Credit Enhancement*

The form and size of credit enhancement for each particular asset pool is dependent upon the nature and quality of the asset pool and the seller/servicer's risk profile. In determining the level of credit enhancement, consideration is given to the seller/servicer's financial strength, quality as a servicer, obligor concentrations, and obligor credit quality, as well as the historic performance of the asset pool. Credit enhancement is generally sized to cover a multiple level of historical losses and dilution for the particular asset pool. Pool-specific credit enhancement can take several forms, including overcollateralization, cash reserves, seller/servicer guarantees (for only highly rated seller/servicers), and subordination. Credit enhancement can either be dynamic (that is, increases as the asset pool's performance deteriorates) or static (that is, fixed percentage). Pool-specific credit enhancement is generally provided by the seller/servicer (or carved out of the asset pool in the case of overcollateralization) but may be provided by other third parties.

## The Loss Waterfall



The ABCP program sponsor or administrator will generally set strict eligibility requirements for the receivables to be included in the purchased asset pool. For example, receivable eligibility requirements will establish minimum credit ratings or credit scores for the obligors and the maximum number of days the receivable can be past due.

Usually the purchased asset pools are structured (credit-enhanced) to achieve a credit-quality equivalent of investment grade (that is, BBB or higher). The sponsoring banking organization will typically utilize established rating agency criteria and structuring methodologies to achieve the desired internal rating level. In certain instances, such as when ABCP programs purchase ABS, the pool-specific credit enhancement is already built into the purchased ABS and is reflected in the security's credit rating. The internal rating on the pool-specific liquidity facility provided to support the purchased asset pool will reflect the inclusion of the pool-

specific credit enhancement and other structuring protections.

### *Program-Wide Credit Enhancement*

The second level of contractual credit protection is the program-wide credit enhancement, which may take the form of an irrevocable loan facility, a standby letter of credit, a surety bond from a monoline insurer, or an issuance of subordinated debt. Program-wide credit enhancement protects commercial paper investors if one or more of the underlying transactions exhaust the pool-specific credit enhancement and other structural protections. The sponsoring banking organization or third-party guarantors are providers of this type of credit protection. The program-wide credit enhancement is generally sized by the rating agencies to cover the potential of multiple defaults in the underlying portfolio of transactions within ABCP conduits and takes into



account concentration risk among seller/servicers and industry sectors.

### *Pool-Specific Liquidity*

Pool-specific liquidity facilities are an important structural feature in ABCP programs because they ensure investors of timely payments on the issued commercial paper by smoothing timing differences in the payment of interest and principal on the pooled assets and ensuring payments in the event of market disruptions. The types of liquidity facilities may differ among various ABCP programs and may even differ among asset pools purchased by a single ABCP program. For instance, liquidity facilities may be structured either in the form of (1) an asset-purchase agreement, which provides liquidity to the ABCP program by purchasing nondefaulted assets from a specific asset pool, or (2) a loan to the ABCP program, which is repaid solely by the cash flows from the underlying assets.<sup>10</sup> Some older ABCP programs may have both pool-specific liquidity and program-wide liquidity coverage, while more-recent ABCP programs tend to utilize only pool-specific facilities. Typically, the seller-provided credit enhancement continues to provide credit protection on an asset pool that is purchased by a liquidity banking organization so that the institution is protected against credit losses that may arise due to subsequent deterioration of the pool.

Pool-specific liquidity, when drawn prior to the ABCP program's credit enhancements, is subject to the credit risk of the underlying asset pool. However, the liquidity facility does not provide direct-credit enhancement to the commercial paper holders. Thus, the pool-specific liquidity facility generally is in an economic second-loss position after the seller-provided credit enhancements and prior to the program-wide credit enhancement even when the legal documents state that the program-wide credit enhancement would absorb losses prior to the pool-specific liquidity facilities. This is because the sponsor of the ABCP program would most likely manage the asset pools in such a way that deteriorating portfolios or assets would be put to the liquidity banking organizations prior to any

10. Direct-liquidity loans to an ABCP program may be termed a *commissioning agreement* (most likely in a foreign bank program) and may share in the security interest in the underlying assets when commercial paper ceases to be issued due to deterioration of the asset pool.

defaults that would require a draw against the program-wide credit enhancement.<sup>11</sup> While the liquidity banking organization is exposed to the credit risk of the underlying asset pool, the risk is mitigated by the seller-provided credit enhancement and the asset-quality test.<sup>12</sup> At the time that the asset pool is put to the liquidity banking organization, the facility is usually fully drawn because the entire amount of the pool that qualifies under the asset-quality test is purchased by the banking organization. However, with respect to revolving transactions (such as credit card securitizations) it is possible to average less than 100 percent of the commitment.

### *Program-Wide Liquidity*

The senior-most position in the waterfall, program-wide liquidity, is provided in an amount sufficient to support that portion of the face amount of all the commercial paper that is issued by the ABCP program that is necessary to achieve the desired external rating on the issued paper. Program-wide liquidity also provides liquidity in the event of a short-term disruption in the commercial paper market. In some cases, a liquidity banking organization that extends a direct liquidity loan to an ABCP program may be able to access the program-wide credit enhancement to cover losses while funding the underlying asset pool.

## APPENDIX B—CREDIT-APPROVAL MEMORANDUM

The credit-approval memorandum typically should include a description of the following:

1. *Transaction structure.* In the beginning of the credit-approval memorandum, the sponsoring banking organization will outline the structure of the transaction, which includes a

11. In fact, according to the contractual provisions of some conduits, a certain level of draws on the program-wide credit enhancement is a condition for unwinding the conduit program, which means that this enhancement is never meant to be used.

12. An asset-quality test or liquidity-funding formula determines how much funding the liquidity banking organization will extend to the conduit based on the quality of the underlying asset pool at the time of the draw. Typically, liquidity banking organizations will fund against the conduit's purchase price of the asset pool less the amount of defaulted assets in the pool.

discussion of the asset type that would be purchased by the ABCP program and the liquidity facilities (and possibly credit enhancements) that the sponsoring banking organization is providing to the transaction. Generally, the sponsoring banking organization indicates the type and dollar volume of the liquidity facility that the institution is seeking to extend to the transaction, such as a \$250 million short-term pool-specific liquidity facility, as well as the type of first-loss credit enhancement that is provided by the seller, such as overcollateralization. The asset purchase by the ABCP conduit from the seller may be described as a two-step sale that first involves the sale of the assets (for example, trade receivables) to an SPV on a true-sale basis and then involves the sale of the assets by the SPV to the ABCP program. Other features of the structure should be described, such as if the transaction is a revolving transaction with a one-year revolving period.

In addition, the sponsoring banking organization typically obtains true-sale and non-consolidation opinions from the seller's external legal counsel. The opinions should identify the various participants in the transaction—including the seller, servicer, and trustee—as appropriate. For instance, the seller of the assets is identified as the party that would act as the servicer of the assets and who is responsible for all the representations and warranties associated with the sold assets.

2. *Asset seller's risk profile.* The assessment of the asset seller's risk profile should consider its past and expected future financial performance, its current market position and expected competitiveness going forward, as well as its current debt ratings. For example, the sponsor may review the seller's leverage, generation of cash flow, and interest coverage ratios, and whether the seller is at least investment grade. Also, the sponsoring banking organization may attempt to anticipate the seller's ability to continue to perform under more-adverse economic conditions. In addition, some sponsors may take other information into account, such as KMV ratings, to confirm their internal view of the seller's financial strength.
3. *Underwriting standards.* A discussion of the seller's current and historical underwriting standards should be included in the transac-

tion summary. For certain types of assets, such as auto loans, the sponsoring banking organization should consider the seller's use of credit scoring and the minimum acceptable loan score that may be included in the asset pool. In addition, the credit-approval memorandum may include an indication of whether the underwriting standards have remained relatively constant over time or whether there has been a recent tightening or loosening.

4. *Asset-eligibility criteria.* In order to reduce the ABCP program's exposure to higher-risk assets, an ABCP program generally specifies minimum asset-eligibility criteria. This is particularly true for revolving transactions since the seller's underwriting standards may change so that the credit quality of the assets purchased by the ABCP program can be adversely affected. While eligibility criteria may be designed for specific transactions, there is a common set of criteria that are generally applicable, including those that exclude the purchase of defaulted assets or assets past due more than a specified number of days appropriate for the specific transaction; limiting excess concentration to an individual obligor; excluding the purchase of assets of obligors that are affiliates of the seller; or limiting the tenor of the assets to be purchased. Other criteria also may require that the obligor be a resident of a certain country and that the asset is payable in a particular currency. All of these criteria are intended to reduce the credit risk inherent in the asset pool to be purchased by the ABCP program. A strong set of eligibility criteria may reduce the necessary credit enhancement provided by the selling organization.
5. *Collection process.* Often, if the seller/servicer has a senior unsecured debt rating of at least BBB-, cash collections may be commingled with the seller/servicer's cash until such time as periodic payments are required to be made to the ABCP program. Documentation should provide an ABCP program with the ability to take steps to control the cash flows when necessary and include covenants to redirect cash flows or cause the segregation of funds into a bankruptcy-remote SPE upon the occurrence of certain triggers. A description of how checks, cash, and debit payments are to be handled may be discussed. For instance, documentation may



- state that payments by check must be processed on the same day they are received by the lockbox and that after the checks clear, the cash is deposited in a segregated collection account at the sponsoring banking organization. Also, the documents may describe the types of eligible investments in which the cash may be invested, which are usually highly rated, liquid investments such as government securities and A1/P1+ commercial paper.
6. *Assets' characteristics.* Usually, a transaction summary will provide a description of the assets that will be sold into the program and outline relevant pool statistics. For instance, there likely will be a discussion of the weighted average loan balance, weighted average credit score (if appropriate), weighted average original term, and weighted average coupon, as well as the ranges of each characteristic. In addition, the portfolio may be segmented by the sponsoring banking organization's internal-rating grades to give an indication of each segment's average credit quality (as evidenced by an average credit score) and share of the portfolio's balances. Many times, the sponsor will identify concentrations to individual obligors or geographic areas, such as states.
  7. *Dilution.* Certain asset types (for example, trade receivables) purchased by ABCP programs may be subject to dilution, which is the evaporation of the asset due to customer returns of sold goods, warranty claims, disputes between the seller and its customers, as well as other factors. For instance, the seller of the assets to the ABCP program may permit its customers to return goods, at which point the receivables cease to exist. The likelihood of this risk varies by asset type and is typically addressed in the transaction summary. For instance, in sales of credit card receivables to an ABCP program, the risk of dilution is small due to the underlying diversity of the obligors and merchants. While the pool-specific liquidity facilities often absorb dilution initially, the seller generally is required to establish a reserve to cover a multiple of expected dilution, which is based on historical information. The adequacy of the dilution reserve is reviewed at the inception of the transaction and may or may not be incorporated in the seller-provided credit enhancement that is provided on the pool of assets sold to the ABCP program.
  8. *Historical performance.* As a prelude to sizing the pool-specific credit enhancement provided by the seller, the sponsoring banking organization will review the historical performance of the seller's portfolio, including consideration of losses (that is, loss rate and loss severity), delinquencies, dilutions, and the turnover rate.<sup>13</sup> An indication of the direction of losses and delinquencies, and the reasons behind any increase or decrease are often articulated. For instance, an increase in losses may reflect losses due to specific industry-related problems and general economic downturns. Typically, the rating agencies prefer at least three years' worth of historical information on the performance of the seller's asset pools, although the rating agencies periodically permit transactions to have less information. As a result, a sponsoring banking organization likely will require the same degree of information as a rating agency whether this is a full three-year history or a lesser amount, as appropriate, when assessing the credit quality of its liquidity and credit-enhancement exposures.
  9. *Termination events.* ABCP programs usually incorporate commercial paper stop-issuance or wind-down triggers to mitigate losses that may result from a deteriorating asset pool or some event that may hinder the ABCP programs' ability to repay maturing commercial paper. Such triggers may be established at either the pool level or program-wide level, and may, if hit, require the ABCP program to immediately stop issuing commercial paper to fund (1) new purchases from a particular seller or (2) any new purchases regardless of the seller. In addition, such triggers may require the ABCP program to begin liquidating specific asset pools or its entire portfolio.
- The rating agencies consider these structural safeguards, which are designed to protect the ABCP program from credit deterioration over time, in determining the rating on an ABCP program's commercial paper. In many ABCP programs, there may be a provision that requires the program to wind down if a certain percentage of the program-wide credit enhancement has been used to

13. The turnover rate of a receivables portfolio is a measure of how fast the outstanding assets are paid off. For example, if a seller had sales of \$4,000 in the prior year and an average portfolio balance of \$1,000, then the turnover rate of the portfolio is four.

cover losses (for example, 25 percent).

Examples of pool-specific triggers include the insolvency or bankruptcy of the seller/servicer; downgrade of the seller's credit rating below a specific rating grade; or deterioration of the asset pool to the point where charge-offs, delinquencies, or dilution rises

above predetermined levels. Program-wide triggers may include (1) the ABCP program's failure to repay maturing commercial paper or (2) when draws reduce the program-wide credit enhancement below a stated threshold.

# Assessing Risk-Based Capital (RBC)—Direct-Credit Substitutes Extended to ABCP Programs

## Examination Objectives

Effective date October 2007

Section 3030.2

Unless otherwise specified, examiners should weigh the importance and significance of the objectives being assessed when he or she determines a final conclusion.

### INTERNAL RISK-RATING SYSTEM

1. To determine if the banking organization has a robust internal risk-rating system.
2. To determine if the banking organization generally has sound risk-management practices and principles.

### INTERNAL RISK-RATING SYSTEM FOR ABCP SECURITIZATION EXPOSURES

1. To determine the extent to which the banking organization integrates its ABCP internal risk-rating process with its credit-risk management framework.
2. To qualitatively assess the suitability of the banking organization's risk-rating process relative to the transactions and type of assets securitized.
3. To assess the adequacy of the credit-approval process.

### INTERNALLY RATED EXPOSURES

1. To determine whether the banking organization applies its internal risk-rating system to liquidity facilities and credit enhancements extended to ABCP programs.
2. To determine whether the assigned internal ratings incorporate all of the risks associated with rated exposures extended to ABCP programs.

### MONITORING OF ABCP PROGRAMS BY RATING AGENCIES

1. To confirm that the commercial paper issued

by the ABCP programs is rated by one or more nationally recognized statistical rating organizations (NRSROs).

2. To verify that NRSROs are monitoring the ABCP programs in order to ensure the maintenance of minimum standards for the respective ABCP program's rating.

### UNDERWRITING STANDARDS AND MANAGEMENT OVERSIGHT

1. To assess the quality and robustness of the underwriting process.

### INTERNAL-RATING CONSISTENCY WITH RATINGS ISSUED BY THE RATING AGENCIES

1. To confirm that whenever ABCP program transactions are externally rated, internal ratings are consistent with, or more conservative than, those issued by NRSROs.

### FIRST-LOSS POSITION FOR PROGRAM-WIDE CREDIT ENHANCEMENT

1. To ascertain the rank order, if possible, of the risk assumed by the various direct-credit substitutes and liquidity facilities in the ABCP program—determining the order in which various exposures would absorb losses.
2. To determine if third-party investors provide program-wide credit enhancement to the ABCP conduit.
3. To determine if the spread that third-party investors or the banking organization charges for taking program-wide credit-enhancement risk is generally within the market's investment-grade pricing range.

### CONCENTRATIONS OF NON-INVESTMENT GRADE SELLER/SERVICERS

1. To determine if the sponsoring banking organization is exposed to an inordinate amount of seller/servicer risk.

### UNDERLYING ASSETS OF THE ABCP PROGRAM STRUCTURED TO INVESTMENT-GRADE RISK

1. To obtain the internal rating for the program-wide credit enhancement in order to deter-

mine the banking organization's assessment of the credit quality of the risk exposure.

2. To rank-order the underlying transactions in the ABCP program on the basis of internal risk ratings in order to determine the notional amount of transactions falling in each of the three ratings categories: investment grade (BBB- or better), high non-investment grade (BB+ to BB-), and low non-investment grade (below BB-).
3. To determine a risk-based capital requirement for the program-wide credit enhancement.

# Assessing Risk-Based Capital (RBC)—Direct-Credit Substitutes Extended to ABCP Programs

## Examination Procedures

Effective date October 2007

## Section 3030.3

### DECISION TREE

The decision tree is intended to assist examiners in determining the adequacy of the internal rating systems used for rating direct-credit substitutes extended to asset-backed commercial paper (ABCP) programs. If examiners consider a banking organization's internal rating system adequate, then the institution may use the internal ratings assigned to calculate the risk-based capital charge for unrated direct-credit substitutes, including program-wide credit enhancements. The determination process can essentially be broken down into individual steps that start by answering broad fundamental risk questions and end with examining more-detailed ABCP program-specific characteristics.

The first six steps (1–6) of the process focus on evaluating the banking organization's risk-rating system, while the final three steps (7–9) are used to determine the amount of risk-based capital to be assessed against program-wide credit enhancements.

### PERFORMING THE EXAMINATION PROCEDURES

Examiners should be mindful that evaluating the adequacy of internal risk-rating systems generally depends on both subjective judgments and objective information generated in each step of the process. When performing the examination procedures, the examiner may determine that certain observed weaknesses in meeting specific supervisory expectations may not necessarily be severe enough to conclude that the internal risk-rating system is inadequate. In some cases, compensating strengths in components of the risk-rating system may offset observed weaknesses. However, examiners should take such weaknesses into consideration in formulating their overall conclusion and consider them when developing recommendations to improve the internal risk-rating process. Failure to meet the regulatory requirements and follow the supervisory guidance typically is an indication of unsafe and unsound banking practices in the risk management of ABCP programs. Where failures are observed, examiners should conclude that use of

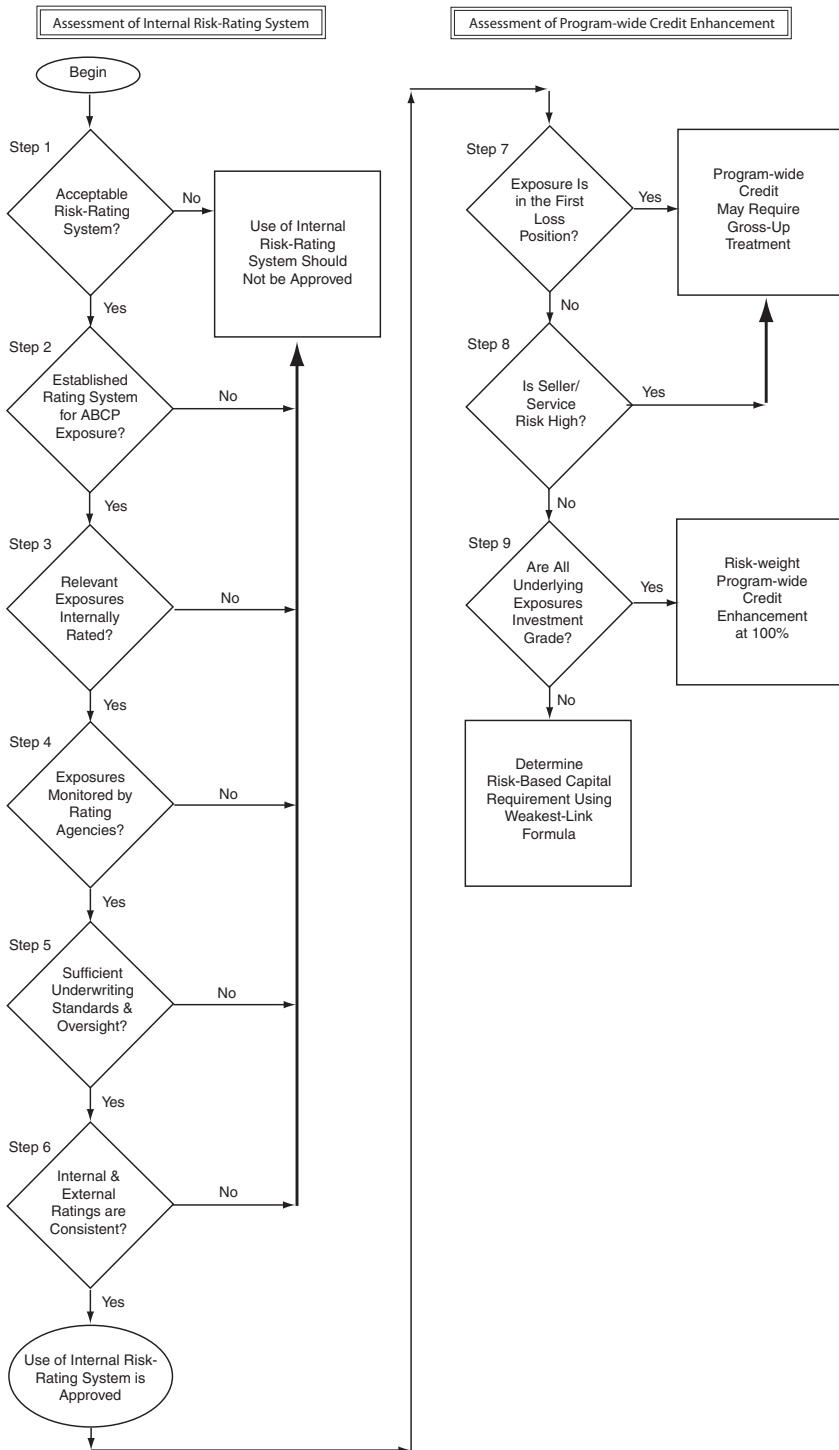
the internal-ratings approach for exposures to ABCP programs is inappropriate for purposes of the respective provisions of the risk-based capital rule.

While this guidance has been designed to address common industry underwriting and risk-management practices, it may not sufficiently address all circumstances. For unique cases not adequately addressed by the guidance, examiners should review the specific facts and circumstances with the responsible Reserve Bank management in conjunction with the Board's Banking Supervision and Regulation staff before rendering a final conclusion.

### Organizing the Examination Process

When organizing the examination, examiners should note if the banking organization operates multiple ABCP conduits. In some cases, a banking organization may manage individual ABCP conduits out of different legal entities or lines of business, and each conduit may focus on different business strategies.

1. Before initiating the examination process, determine—
  - a. the number of ABCP conduits sponsored by the banking organization,
  - b. which ABCP conduits have direct-credit substitutes provided by the banking organization, and
  - c. from what areas within the organization these activities are conducted.
2. When multiple ABCP conduits exist, assess whether the banking organization applies the internal risk-rating system consistently to each program with identical policies, procedures, and controls.
3. If the banking organization operates ABCP program activities out of different legal entities or lines of business, or if the application of an internal rating system varies from program to program, evaluate the adequacy of each unique application.
4. Consider limiting any Federal Reserve approval of the use of internal ratings to those programs that have been examined and determined to meet the requirements outlined in this guidance.



- Banking organizations may have established ABCP lines of business from which they coordinate client relationships, transaction-origination activities, funding activities, and ABCP conduit management. An inspection of such “front-office” operations can provide important insight into the unique characteristics of the banking organization’s ABCP program. Examiners should focus the examination’s review on the areas of the organization where credit decisions and credit-risk management are housed and where oversight of the internal risk-rating system is maintained.
5. Consider the factors listed below while conducting the banking organization’s examination. When any of these factors are observed, perform a more thorough review of its internal controls, risk management, and potential weaknesses before approving the banking organization’s internal risk-rating system.

Although observation of a single factor may not be compelling enough for withholding approval, the examiner’s observation of one or more of these factors should result in the adoption of a more conservative bias as the examination procedures are performed.

*If a combination of the risk factors identified below is observed during the examination process, the examiner may determine that the internal risk-rating system should not be relied upon for assessing the risk-based capital treatment for direct-credit substitutes provided to ABCP programs.*

The following factors should be considered:

1. The sponsoring banking organization has a short track record and is inexperienced in the management of an ABCP program.
2. The transaction-specific credit enhancement is solely in the form of excess spread.
3. Significantly higher ABCP program costs exist for program-wide credit enhancement as compared with the internal and external benchmarks for investment-grade risk.
4. The sponsoring banking organization fails to maintain historical ratings-migration data or the migration data of required credit-enhancement levels.
5. There is an excessive number of transaction-rating migrations (both internal and external), or excessive collateral calls are necessary to enhance transaction-level credit

- enhancement to maintain an internal risk rating.
6. The transactional due-diligence, approval, or execution documentation is poorly prepared.
7. A significant number of problem transactions are taken out of the ABCP program through liquidity draws.
8. There is no independent review or oversight of the internal rating system or the assigned transaction ratings. A review conducted by internal parties within the sponsoring/administrating banking organization may still be considered independent so long as the business unit conducting the review does not report to the unit that is responsible for the ABCP program’s transactions.
9. The transaction-underwriting and risk-management functions of an ABCP program sponsor/administrator, other than routine outside audit reviews, are delegated to unaffiliated third parties.
10. The ABCP conduit commercial paper is not rated lower than A-2/P2 on an ongoing basis by the rating agencies.

*If examiners observe either of the following two factors, the banking organization should not receive Federal Reserve approval to use the internal-ratings approach. (See the examination procedures for more detail.)*

11. The banking organization does not have, in the examiner’s view, an established or acceptable internal risk-rating system to assess the credit quality of its exposures to its ABCP programs.
12. Relevant direct-credit substitutes or liquidity facilities are not internally risk rated.

### Step 1—Acceptable Internal Risk-Rating Systems

1. Determine if the banking organization is able to satisfactorily demonstrate how its internal risk-rating system corresponds to the rating agencies’ standards used as the framework for complying with the securitization requirements in the risk-based capital rule. Ascertain whether the credit ratings map to the risk-weight categories in the ratings-based approach so they can be applied to internal ratings.

2. If a separate supervisory team has conducted a detailed evaluation of the robustness and effectiveness of the banking organization's overall internal ratings system, use the inspection work to assess the application of internal ratings specific to the banking organization's ABCP programs. Consider reducing the procedures to a quick review of the previous examination's findings.
3. If there was no previous evaluation of the banking organization's risk-rating system or if documentation of the evaluation findings is unavailable, perform a full review of the organization's risk-rating system.
4. Ascertain whether the banking organization's overall risk-rating process is generally consistent with the fundamental elements of sound risk management and with the rating assumptions and methodologies of the rating agencies.
  - a. Determine if the internal ratings are incorporated into the credit-approval process and are considered in the pricing of credit.
  - b. Find out if the internal lending and exposure limits are linked to internal ratings.
5. Verify that the internal risk-rating system for ABCP programs contains the following nine criteria:
  - a. The internal credit-risk system is an integral part of the banking organization's risk-management system, which explicitly incorporates the full range of risks arising from its participation in securitization activities.
  - b. Internal credit ratings are linked to measurable outcomes, such as the probability that the position will experience any loss, the position's expected loss given default, and the degree of variance in losses given default on that position.
  - c. The banking organization's internal credit-risk system separately considers (1) the risk associated with the underlying loans or borrowers and (2) the risk associated with the structure of a particular securitization transaction.
  - d. The banking organization's internal credit-risk system identifies gradations of risk among "pass" assets and other risk positions.
  - e. The banking organization has clear, explicit criteria, including subjective factors, that are used to classify assets into each internal risk grade.
  - f. The banking organization has independent credit-risk management or loan-review personnel assigning or reviewing the credit-risk ratings.
  - g. The banking organization has an internal audit procedure that periodically verifies that internal risk ratings are assigned in accordance with the organization's established criteria.
  - h. The banking organization (1) monitors the performance of the internal credit-risk ratings assigned to nonrated, nontraded direct-credit substitutes over time to determine the appropriateness of the initial credit-risk rating assignment and (2) adjusts individual credit-risk ratings, or the overall internal credit-risk ratings system, as needed.
  - i. The internal credit-risk system makes credit-risk rating assumptions that are consistent with, or more conservative than, the credit-risk rating assumptions and methodologies of the nationally recognized statistical rating organizations (NRSROs).

*If all of the above supervisory guidance is not adhered to, the use of internal ratings under the risk-based capital rule should not be approved.*

## Step 2—Use of an Established Internal Risk-Rating System Tailored to ABCP Securitization Exposures

1. Determine if an internal rating system exists that assesses exposures (for example, liquidity facilities) provided to ABCP programs.
2. Ascertain whether there is evidence that the ABCP internal risk-rating process is an integrated component of the enterprise-wide credit-risk management process. This includes—
  - a. risk ratings that are a fundamental portfolio management tool and
  - b. internal ratings that are considered in credit and pricing decisions.
3. Evaluate whether the management team and staff are experienced with the types of assets and facilities internally rated for the ABCP program.
4. Determine if there is meaningful differentiation of risk. Verify that—
  - a. separate ratings are applied to borrowers and facilities that separately consider the



- risk associated with the underlying loans and borrowers, as well as the risk associated with the specific positions in a securitization transaction, and
- b. a distinct set of rating criteria exists for each grade. The banking organization should have classified its assets into each risk grade using clear, explicit criteria, even for subjective factors.
5. Verify that the risk-ratings criteria for ABCP transactions are documented with specific methodologies detailed for different asset types.
  6. Find out if the banking organization includes a transaction summary<sup>1</sup> as part of its credit-approval process. The transaction summary should include a description of the following: transaction structure, seller/servicer's risk profile,<sup>2</sup> relevant underwriting criteria, asset-eligibility criteria, collection process, asset characteristics, dilution and historical loss rates, and trigger and termination events. (See appendix B of section 3030.1 for a more detailed description of the above transaction-summary categories.)
  7. Before reaching a final assessment, consult with the other examiners who have conducted reviews of the banking organization's other risk-rating systems, including the corporate risk-rating system.

### Step 3—Relevant Internally Rated Exposures

1. Verify that the banking organization internally rates all relevant exposures to ABCP programs, such as pool-specific liquidity facilities.
2. Ascertain if the banking organization maps its internal ratings to the full scale of external ratings provided by the NRSROs.

### Step 4—ABCP Program Monitored by Rating Agencies

1. Verify that the commercial paper issued by

1. The transaction summary may not be specifically identified, but its elements would be part of the credit-approval process.

2. The seller/servicer's risk profile may be developed by a group within the banking organization other than the ABCP program group and incorporated into the transaction summary by reference.

- the ABCP program has been rated in the second-highest short-term rating category (A2, P2, or F2) or higher.
2. Confirm that there is evidence that rating agencies are actively monitoring the structuring methodologies and credit quality of the transactions purchased by the ABCP conduit.
    - a. *Prescreened programs.* Confirm that NRSROs are prescreening each new transaction placed in the ABCP program.
    - b. *Post-review programs.* Find out if ABCP program transactions are monitored by the NRSROs via monthly or quarterly reports. Determine if the banking organization is promptly forwarding information on new transactions and transactions experiencing deterioration to the NRSROs (for example, through monthly reports).

### Step 5—Sufficient Underwriting Standards and Management Oversight

1. Determine if the banking organization has internal policies addressing underwriting standards that are applicable to ABCP programs.
2. For each ABCP transaction, ascertain whether the institution applies the following factors in its underwriting process:

#### a. *General Portfolio Characteristics:*

- an understanding of the operations of the businesses that originates the assets being securitized
- a review of the general terms offered to the customer
- a determination of the quality of assets and from which legal entity assets are originated
- a determination of customer, industry, and geographic concentrations
- an understanding of the recent trends in the business that may affect any historical information about the assets

#### b. *Legal Structure of the Transaction:*

- A general structuring of transactions as “bankruptcy-remote” via a legal “true sale” of assets rather than as

secured loans. (This reduces the likelihood that a creditor of the seller can successfully challenge the security interest in the asset pool in the event of seller insolvency.) Determine if the banking organization maintains copies of true-sale opinions in the facility file or as a part of the facility's legal documents.

- An appropriate management level in the credit-approval hierarchy that is responsible for reviewing transactions that do not have a bankruptcy-remote “true-sale” structure.
- Uniform commercial code (UCC) filings and searches on securitized assets. (UCC filings are often needed to ensure that asset transfers resist third-party attack [that is, are “perfected”]). UCC searches often ensure that asset transfers are not subject to a higher-priority security interest (that is, that the banking organization's interests are “first priority”). If such filings and searches have not been performed, examiners should make further inquiry. There may be a satisfactory reason for not using the UCC filing system.
- Transactions that include a contractual representation or a legal opinion ensuring that there are no provisions, such as negative pledges or limitations on the sale of assets, that would prohibit the securitization transaction.

#### *c. Transaction-Specific Credit Enhancements*

Transaction-specific credit enhancement takes a variety of forms depending upon the asset type. For instance, credit enhancement relating to trade receivables may consist of the following types of reserves:

- loss reserve—reserves related to obligor default risk
- dilution reserve—reserves related to non-cash reductions of balances
- servicing reserve—reserves related to fees for servicing and trustees

The loss and dilution reserves typically account for most of the reserves.

Reserves may take a number of different forms, including recourse to the seller (if the seller is of high credit quality), funded cash reserves, and over-collateralization.

- (1) Determine if the credit-approval chain carefully scrutinizes transactions in which reserves are in the form of recourse to a seller with weak credit quality.
- (2) Ascertain if the banking organization's criteria for structuring the appropriate reserve levels are generally consistent with rating agency criteria for a particular asset class.
- (3) Review and consider the relevant rating agency methodology when evaluating reserves for any particular transaction.

#### *d. Eligibility Criteria*

Eligibility criteria are structured into securitization transactions to restrict (or limit) the inclusion of certain categories of receivables as appropriate to the particular transaction. Examples of such restricted categories may include:

- delinquent receivables (based on a stated aging policy, such as 30 days past due)
- receivables of bankrupt obligors
- foreign receivables
- affiliate receivables
- receivables of obligors with delinquent balances above a certain amount
- bill and hold receivables
- unearned receivables
- non-U.S.-dollar-denominated receivables
- receivables subject to offset
- disputed receivables
- receivables with a payment date beyond a specified time horizon
- post-petition receivables

*The above list is illustrative and should not be considered comprehensive.*

- (1) Conduct further analysis when there is a lack of any specific eligibility criteria (for example, those listed above) that warrants a further determination as to whether the banking

organization has taken appropriate measures to alleviate any particular risk arising from the lack of a specific feature.

*e. Concentrations*

- (1) Analyze obligor, industry, and geographic concentrations.
- (2) Ascertain if the appropriate concentration limits have been established within transaction documents, often within the eligibility criteria.

*f. Trigger Events and Termination Events*

The inclusion of trigger and termination events plays a critical role in securitization structures. It is standard practice to have trigger or termination events related to the performance of the assets and, depending upon the asset type, to the seller/servicer. Trigger events are comparable to performance covenants in corporate debt and provide a lender with the ability to accelerate a transaction, when appropriate. In addition, such triggers create incentives that allow the seller and the banking organization to negotiate higher levels of credit enhancement or add further restrictions to eligibility criteria when the receivables' performance metrics indicate deterioration beyond an established trigger level. In a similar way, termination events are established to begin the early termination of the transaction when the receivable performance deteriorates. Typical trigger events are based on one or more of the following performance metrics:

- asset coverage ratio
- delinquencies
- losses
- dilution

Termination events may include these same metrics but may also include the bankruptcy, insolvency, change of control of the seller/servicer, or the failure of the servicer to perform its responsibilities in full.

*g. Due-Diligence Reviews*

- (1) Ascertain if the banking organization conducts due-diligence reviews prior to closing its ABCP transactions. Determine if such reviews were tailored to the asset type being securitized and the availability of audit information. A frequent public asset-backed securities (ABS) issuer that accesses conduit funding or a seller that has strong credit quality may be eligible for a post-closing review, provided recent audit results are obtained. If not, it should be subject to pre-closing review. For example, a review tailored to trade receivables should focus on most of the following:
  - Confirming the receivable information (balances, sales, dilution, write-offs, etc.) previously provided by the seller, with the seller's books and records over at least two reporting periods. Such a review might be performed by a third-party auditor.
  - Sampling invoices against the seller's aged trial balance to test the accuracy of agings.
  - Sampling past invoices to determine ultimate resolution (paid, credited, written-off, etc.)
  - Sampling credits against their respective invoices to test the dilution horizon.
  - Sampling write-offs to determine timing and reasons for write-offs.
  - Reviewing significant customer concentrations, including delinquent balances.
  - Determining systems capability with respect to transaction reporting and compliance.
  - Reviewing credit files for completeness and conformity with credit policies.
  - Reviewing collection systems and determining the portion of cash going into segregated lockboxes or bank accounts.
  - Reviewing internal and external auditor reports to the extent that such documents are available for review.

- Noting any unusual items that may complicate the receivable transaction.
- (2) Determine if ABCP transactions are reviewed at least annually.
- Confirm that the banking organization verifies the accuracy of the monthly servicer's transaction reports, including compliance with sale and servicing requirements.
  - Determine if an increased review frequency is needed for any issues raised in prior reviews, transactions with higher-risk sellers, and transactions serviced out of multiple locations.

#### *h. Cash Management*

- (1) Assess a seller's cash-management practices. Commingling of cash collections can cause a loss in the perfected security interest of cash flows, particularly in the event of seller insolvency.
- Determine if, preferably, the banking organization requires that all payment collections flow into a single, segregated lockbox account to minimize cash-commingling risk.
  - For trade receivables, find out if the banking organization requires that the cash collections be reinvested in new receivables to eliminate cash-commingling risk.
- (2) For higher-risk sellers, determine if the banking organization—
- establishes an account in the name of the trust or special-purpose vehicle (SPV) into which collections could be swept on a daily basis or
  - requires that settlement be done weekly, or daily, ensuring that there are always sufficient receivables to cover investments and reserves.

#### *i. Reporting*

When underwriting a portfolio, it is important to decide what information

should be required in the monthly report.

- (1) Determine if quarterly, or more frequent, reports for a trade receivable transaction include the following:
- beginning balances
  - sales
  - cash collections
  - dilution or credits
  - write-offs
  - ending balances
  - delinquencies by aging bucket
  - ineligible assets
  - total eligible receivables
  - excess concentrations
  - net receivable balance
  - conduit investment
  - conduit's purchased interest
  - calculation of receivable performance termination events
  - top 10 obligor concentrations
- (2) Ascertain if the banking organization has established other special reporting requirements based on the particular pool of receivables being securitized.

#### *j. Receivable Systems*

- (1) Because of the significant reporting requirements in a securitization transaction, verify that the banking organization assesses—
- the seller's receivable systems to determine if they will be sufficient to provide the required information and
  - the seller's data backup and disaster recovery systems.

#### *k. Quality of Seller/Servicer*

- (1) Verify that the banking organization performs an assessment of the creditworthiness of the seller that is conducted from the relationship side.
- (2) Determine if the banking organization conducts a more focused assessment on the seller/servicer's management team that is involved in the day-to-day receivables operation (that is, credit, accounting, sales, servicing, etc.).

### *l. Performance Monitoring*

- (1) Find out whether the banking organization has developed and uses a performance-monitoring plan that periodically monitors the portfolio.
  - Determine if there is appropriate monitoring that allows the designated administrator to review relevant pool performance to evaluate the level of available funding under the asset-quality tests in the related liquidity facility.
  - Determine if the banking organization tests these conditions when the seller reports performance data relating to an underlying transaction (usually monthly or quarterly).

Typically, a liquidity facility has a funding condition based on asset quality whereby the liquidity provider will not advance against any receivable that is considered defaulted. A performance-monitoring plan may entail monitoring the run rate of defaulted assets so that the potential losses do not exceed the loss protection.

### *m. Post-Closing Monitoring*

- (1) Determine if the banking organization's underwriting team assists the portfolio management team in developing all of the items that should be tracked on the transaction, including the development of a spreadsheet that ensures the capture and calculation of the appropriate information.

### *n. Underwriting Exceptions*

- (1) If a banking organization approves a transaction after it has agreed to an exception from standard underwriting procedures, find out if the banking organization closely monitors and periodically evaluates the policy exception.

*Banking organizations may utilize variations of the above-listed underwriting standards.*

- (2) Evaluate the robustness of the underwriting process and determine if it is comparable to stated rating agency criteria. If weaknesses in the underwriting process are found, determine if there are any existing compensating strengths and any other relevant factors to be considered when determining its overall assessment.
- (3) If the examiner determines that the supervisory expectations generally are not met, he or she should not recommend to the appropriate Reserve Bank supervisory official that the use of internal ratings, under the securitization capital rule, be approved.

### **Step 6—Consistency of Internal Ratings of ABCP Program's Exposures with Ratings Issued by the Rating Agencies**

1. Find out if any underlying transactions funded through ABCP programs are externally rated by one or more rating agencies.
2. Confirm if the mapping of the internal ratings assigned to these transactions is consistent with, or more conservative than, those issued by NRSROs.
3. When the underlying transactions are split-rated by two or more rating agencies, determine if the internal ratings are consistent with the most conservative (lowest) external rating.
4. Ascertain that the above exceptions do not represent more than a small fraction of the total number of transactions that are externally rated. If such exceptions exist, determine if there are generally an equal or larger percentage of externally rated transactions where internal ratings are more conservative than the external rating.

*If supervisory expectations are not met, then the internal risk-rating system may not be appropriately mapped to the external ratings of an NRSRO. In such cases, further review of the adequacy of the banking organization's risk-rating system must be undertaken before the use of internal ratings under the securitization capital rule can be approved.*

### *Determine Adequacy of Internal Ratings Systems*

If, through the examination process, the internal risk-rating system utilized for ABCP exposures is found to be inadequate, then the banking organization may not apply the internal risk-ratings approach to ABCP exposures for risk-based capital purposes until the organization has remedied the deficiencies. Banking organizations that have adequate risk-rating systems that are well integrated into risk-management processes applied to ABCP programs may be approved for use of the internal risk-ratings approach.

Once a banking organization's internal rating system is deemed adequate, the organization may use its internal ratings to slot ABCP exposures, including pool-specific liquidity facilities, into the appropriate rating category (investment grade, high non-investment grade, and low non-investment grade), and apply the corresponding risk weights. However, due to the unique nature of program-wide credit enhancements, further guidance is provided in steps 7 through 9 to help establish the appropriate capital requirement.

### *Step 7—Determination of Whether Program-Wide Credit Enhancements Are in the First-Loss Position*

1. Determine if the ABCP program documentation confirms that the program-wide credit enhancement is not the first-loss credit enhancement for any transaction in the ABCP program and is, at worst, in the second-economic-loss position, usually after transaction-specific credit enhancements.
2. Verify if the spread charged for the program-wide credit enhancement is the spread range of investment-grade exposures of a term securitization. Consider other factors that may influence pricing, such as availability of the credit enhancement.
3. Find out if the financial guarantee providers, such as AMBAC, FSA, and FGIC, participate in a program-wide credit-enhancement tranche either on a senior position or on a pari-passu position with other providers. The risk taken by these institutions is usually investment grade.
  - a. Compare the price of the guarantee charged by these institutions to the pricing

ranges of non-investment-grade and investment-grade exposures of the sponsoring banking organization, the loan syndication market, and the bond market. This may be a gauge as to whether a third party considers the risk as investment grade or non-investment grade.

- b. Reference such sources for reviewing market pricing as Loan Pricing Corporation's Gold Sheets and Bloomberg (for bond spreads). A range or average pricing for both investment-grade and non-investment-grade syndicated loans can be found in the Gold Sheets.
- c. Similarly, review also the price the sponsor/banking organization is charging for its respective portion of the program-wide credit enhancement.

### *Step 8—Risk Levels Posed by Concentrations of Non-Investment-Grade Seller/Servicees*

1. Confirm that the banking organization's internal risk-rating systems properly account for the existence of seller/servicer risk.

An asset originator (that is, the entity selling the assets to the ABCP program) typically is the servicer and essentially acts as the portfolio manager for the ABCP program's investment. The servicer identifies receivables eligible for the ABCP program and manages to preserve the investment on behalf of the banking organization sponsoring the ABCP program. As previously discussed, servicer risk can be partially mitigated through seller allocation and structuring payments to protect against commingling of cash.

2. Determine if the banking organization has specific transaction structures, such as a backup servicer, in place to mitigate servicer risk.
3. Ascertain if exposure to an excessive number of non-investment-grade servicers adversely affects the overall credit quality of the ABCP program, exposing the conduit to the higher bankruptcy risk that inherently exists with non-investment-grade obligors.
4. Use the benchmarks below to assess the banking organization's potential exposures to non-investment-grade seller/servicer con-



centrations in its ABCP program. Depending on the circumstances, concentrations exceeding these benchmarks may be considered as unsafe and unsound banking practices.

- a. Determine, based on the grid below, the percentage of securitized assets from non-investment-grade servicers to the total outstandings of an ABCP program that has a lower weighted average rating of all the transactions in the program. For example, if the ABCP program transactions have a weighted average rating equivalent to “BBB,” no more than 30 percent of the total outstandings of the ABCP program should be represented by non-investment-grade seller/servicers. However, an ABCP program that has transactions structured to a higher weighted average rating, such as a single “A” equivalent, could have up to 60 percent of the outstandings originated by non-investment-grade seller/servicers without causing undue concerns.

<i>Weighted average rating equivalent of transactions</i>	<i>Servicer percentage below investment grade</i>
AA	90%
AA–	80%
A+	70%
A	60%
A–	50%
BBB+	40%
BBB	30%
BBB–	20%
BB+	10%

### Step 9—The Portion of Underlying Assets of the ABCP Program Structured to Investment-Grade Risk

1. Determine the appropriate amount of risk-based capital that should be assessed against the program-wide credit enhancement based on the internal risk ratings of the underlying transactions in the ABCP program.
  - a. If *all* underlying transactions are rated investment grade, risk-weight the notional amount of the program-wide credit enhancement at 100 percent.
  - b. If one or more of the underlying transac-

tions are internally rated below investment grade, then consider using the following weakest-link approach to calculate an appropriate risk-based capital charge for the program-wide credit enhancement.

The approach takes into account the internal ratings assigned to each underlying transaction in an ABCP program. These transaction-level ratings are typically based on the internal assessment of a transaction’s pool-specific liquidity facility and the likelihood of its being drawn. The transactions are rank-ordered by their internal rating and then bucketed into the three ratings categories: investment grade, high non-investment grade, and low non-investment grade. The program-wide credit enhancement is then assigned an appropriate risk weight based upon the notional amount of transactions in each ratings bucket.

Under the weakest-link approach, the risk of loss corresponds first to the weakest transactions to which the program-wide credit enhancement is exposed. Banking organizations should begin with the lowest bucket (low non-investment grade) and then move to the next-highest rating bucket until the entire amount of the program-wide credit enhancement has been assigned. The assigned risk weights and their associated capital charges are then aggregated. However, if the risk-based capital charge for the non-investment-grade asset pools equals or exceeds the 8 percent charge against the entire amount of assets in the ABCP program, then the risk-based capital charge is limited to the 8 percent against the program’s assets.

Banking organizations that sponsor ABCP programs may have other methodologies to quantify risk across multiple exposures. For example, collateralized debt obligation (CDO) ratings methodology takes into account both the probability of loss on each underlying transaction and correlations between the underlying transactions. This and other methods may generate capital requirements equal to or more conservative than those arrived at via the weakest-link method. Regardless of the approach used, well-managed institutions should be able to support their risk-based capital calculations.

*Weakest-Link Formula*

IF  $[(0.16 * NI1) + NI2^{**}] \geq (0.08 * PROG)$ , THEN  $RBC = (0.08 * PROG)$   
 Else

Capital =  $[0.08 * (PWC - (NI1 + NI2))] + 0.16 * NI1 + [NI2^{**}]$

\*\*Although the term NI2 should reflect a gross-up charge under the securitization capital rule (that is, an effective 1,250 percent risk weight), for the sake of simplicity a dollar-for-dollar charge is used here. The reason for using dollar-for-dollar is based on the assumption that the NI2 portion of an ABCP pool is typically smaller than the gross-up charge would be on the entire pool. Thus, instead of grossing-up the NI2 portion and then applying the low-level-exposure rule (which, if NI2 is less than the gross-up charge, will yield a dollar-for-dollar capital charge), the term just assumes the dollar-for-dollar amount.

In any event, the risk-based capital charge on the program-wide credit enhancement will never exceed the maximum contractual amount of that program-wide credit enhancement (that is, the low-level-exposure rule).

RBC = Risk-based capital

PROG = Notional amount of all underlying exposures in the program

PWC = Notional amount of program-wide credit enhancement

IG = Notional amount of exposures rated BBB- or better

NI1 = Notional amount of exposures rated between BB+ and BB-

NI2 = Notional amount of exposures rated below BB-

*Example 1*

ABCP program size (PROG) = \$1,000 MM

Program-wide credit enhancement (PWC) = \$100 MM

Total amount of investment grade (IG) = \$995 MM

Total amount of high non-investment grade (NI1) = \$4 MM

Total amount of low non-investment grade (NI2) = \$1 MM

*Example 2*

ABCP program size (PROG) = \$1,000 MM

Program-wide credit enhancement (PWC) = \$150 MM

Total amount of investment grade (IG) = \$940 MM

Total amount of high non-investment grade (NI1) = \$50 MM

Total amount of low non-investment grade (NI2) = \$10 MM

*Weakest Link*

RBC = IF  $[(0.16 * 4) + 1] \geq (0.08 * 1,000)$ , then  
 $RBC = (0.08 * 1,000)$   
 $= \$1.64 \text{ MM} < \$80 \text{ MM}$

Else

$RBC = [(0.08 * (100 - (4 + 1))] + (0.16 * 4) + (1)$

$RBC = (7.60) + (0.64) + (1)$   
 $= \$ 9.24 \text{ MM}$

*Weakest Link*

RBC = IF  $[(0.16 * 50) + 10] \geq (0.08 * 1,000)$ , then  
 $RBC = (0.08 * 1,000) = \$18 \text{ MM}$   
 $< \$80 \text{ MM}$

Else

$RBC = [(0.08 * (150 - (50+10))] + (0.16 * 50) + (10)$

$RBC = (7.20) + (8.00) + (10)$   
 $= \$25.2\text{MM}$



*Example 3*

ABCP program size (PROG) = \$1,000 MM  
 Program-wide credit enhancement (PWC) = \$150 MM  
 Total amount of investment grade (IG) = \$0 MM  
 Total amount of high non-investment grade (NI1) = \$500 MM  
 Total amount of low non-investment grade (NI2) = \$500 MM

*Weakest Link*

RBC = IF  $[(0.16 * 500) + 500] \geq (0.08 * 1,000)$ ,  
 THEN RBC =  $(0.08 * 1,000) = \$580 \text{ MM} >$   
 \$80 MM

Therefore,

RBC =  $(0.08 * 1,000) = \$80 \text{ MM}$

Because \$580 MM is greater than the \$80 MM capital charge that would apply if all of the assets supported by the PWC were on-balance-sheet, the maximum risk-based capital charge is \$80 MM.

When the sum of all non-investment-grade asset pools (that is, NI1 + NI2) exceeds the amount of the program-wide credit enhancement, the weakest-link formula would result in

too much risk-based capital being assessed. If this situation arises, banking organizations should first apply the gross-up treatment to the NI2 asset pools and then assess 16 percent risk-based capital against an amount of the NI1 asset pools that, when added with the NI2 asset pools, would equal the amount of the program-wide credit enhancement. For example, if the program-wide credit enhancement is \$100 on underlying transactions totaling \$1,000, and the underlying exposures are \$10 low non-investment grade, \$100 high non-investment grade, and \$890 investment grade, then risk weighting will be based on the gross-up approach for \$10 and assigning the remaining \$90 to the 200 percent risk-weight category, as shown below:

$\$10 * 1,250\% * 8\%$	=	\$10.00
$\$90 * 200\% * 8\%$	=	\$14.40
Total		<u>\$24.40</u>

Finally, the aggregate capital charge, \$24.40 in this case, is then compared to the capital charge imposed on the underlying transactions if all the program assets were on the banking organization's balance sheet (that is,  $0.08 * \$1,000 = \$80$ ); the lower amount prevails. This establishes the capital charge for the program-wide credit enhancement.

# Assessing Risk-Based Capital—Direct-Credit Substitutes Extended to ABCP Programs Internal Control Questionnaire

Effective date October 2007

Section 3030.4

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1. Does the banking organization have an acceptable risk-rating system?
  2. Does the banking organization use an established internal risk-rating system tailored to ABCP securitization exposures?
  3. Are the relevant exposures internally rated?
  4. Are the ABCP programs monitored by rating agencies?
  5. Are there sufficient underwriting standards and management oversight?
  6. Are internal ratings of ABCP program exposures consistent with ratings issued by the rating agencies?
  7. Is program-wide credit enhancement in the first-loss position?
  8. Do concentrations of non-investment-grade seller/services pose an excessive level of risk?
  9. What portion of the underlying assets of the ABCP programs is structured to investment-grade risk?

[Reserved]

# Sound Incentive Compensation Policies

Effective date October 2010

## Section 4008.1

Incentive compensation practices in the financial industry were one of many factors that contributed to the financial crisis that began in mid-2007. Banking organizations too often rewarded employees for increasing the organization's revenue or short-term profit without adequate recognition of the risks the employees' activities posed to the organization.<sup>1</sup> These practices exacerbated the risks and losses at a number of banking organizations and resulted in the misalignment of the interests of employees with the long-term well-being and safety and soundness of their organizations. This section provides guidance on sound incentive compensation practices to banking organizations supervised by the Federal Reserve (also the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the "Agencies")).<sup>2</sup> This guidance is intended to assist banking organizations in designing and implementing incentive compensation arrangements and related policies and procedures that effectively consider potential risks and risk outcomes.<sup>3</sup>

Alignment of incentives provided to employees with the interests of shareholders of the organization often also benefits safety and soundness. However, aligning employee incentives with the interests of shareholders is not always sufficient to address safety-and-soundness concerns. Because of the presence of the federal safety net (including the ability of insured depository institutions to raise insured deposits and access the discount window and payment ser-

vices of the Federal Reserve), shareholders of a banking organization in some cases may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness. Accordingly, the Federal Reserve expects banking organizations to maintain incentive compensation practices that are consistent with safety and soundness, even when these practices go beyond those needed to align shareholder and employee interests.

To be consistent with safety and soundness, incentive compensation arrangements<sup>4</sup> at a banking organization should:

1. Provide employees incentives that appropriately balance risk and reward;
2. Be compatible with effective controls and risk-management; and
3. Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

These principles, and the types of policies, procedures, and systems that banking organizations should have to help ensure compliance with them, are discussed later in this guidance.

The Federal Reserve expects banking organizations to regularly review their incentive compensation arrangements for all executive and non-executive employees who, either individually or as part of a group, have the ability to expose the organization to material amounts of risk, as well as to regularly review the risk-management, control, and corporate governance processes related to these arrangements. Banking organizations should immediately address any identified deficiencies in these arrangements or processes that are inconsistent with safety and soundness. Banking organizations are responsible for ensuring that their incentive compensation arrangements are consistent with the prin-

1. Examples of risks that may present a threat to the organization's safety and soundness include credit, market, liquidity, operational, legal, compliance, and reputational risks.

2. As used in this guidance, the term "banking organization" includes national banks, state member banks, state nonmember banks, savings associations, U.S. bank holding companies, savings and loan holding companies, Edge and agreement corporations, and the U.S. operations of foreign banking organizations (FBOs) with a branch, agency, or commercial lending company in the United States. If the Federal Reserve is referenced, the reference is intended to also include the other supervisory Agencies.

3. This guidance (see 75 Fed. Reg. 36395, June 25, 2010, for the entire text) and the principles reflected herein are consistent with the *Principles for Sound Compensation Practices* issued by the Financial Stability Board (FSB) in April 2009, and with the FSB's *Implementation Standards* for those principles, issued in September 2009.

4. In this guidance, the term "incentive compensation" refers to that portion of an employee's current or potential compensation that is tied to achievement of one or more specific metrics (e.g., a level of sales, revenue, or income). Incentive compensation does not include compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary). In addition, the term does not include compensation arrangements that are determined based solely on the employee's level of compensation and does not vary based on one or more performance metrics (e.g., a 401(k) plan under which the organization contributes a set percentage of an employee's salary).

ciples described in this guidance and that they do not encourage employees to expose the organization to imprudent risks that may pose a threat to the safety and soundness of the organization.

The Federal Reserve recognizes that incentive compensation arrangements often seek to serve several important and worthy objectives. For example, incentive compensation arrangements may be used to help attract skilled staff, induce better organization-wide and employee performance, promote employee retention, provide retirement security to employees, or allow compensation expenses to vary with revenue on an organization-wide basis. Moreover, the analysis and methods for ensuring that incentive compensation arrangements take appropriate account of risk should be tailored to the size, complexity, business strategy, and risk tolerance of each organization. The resources required will depend upon the complexity of the firm and its use of incentive compensation arrangements. For some, the task of designing and implementing compensation arrangements that properly offer incentives for executive and non-executive employees to pursue the organization's long-term well-being and that do not encourage imprudent risk-taking is a complex task that will require the commitment of adequate resources.

While issues related to designing and implementing incentive compensation arrangements are complex, the Federal Reserve is committed to ensuring that banking organizations move forward in incorporating the principles described in this guidance into their incentive compensation practices.<sup>5</sup>

As discussed further below, because of the size and complexity of their operations, large complex banking organizations (LCBOs)<sup>6</sup> should

have and adhere to systematic and formalized policies, procedures, and processes. These are considered important in ensuring that incentive compensation arrangements for all covered employees are identified and reviewed by appropriate levels of management (including the board of directors where appropriate and control units), and that they appropriately balance risks and rewards. In several places, this guidance specifically highlights the types of policies, procedures, and systems that LCBOs should have and maintain but that generally are not expected of smaller, less complex organizations. LCBOs warrant the most intensive supervisory attention because they are significant users of incentive compensation arrangements and because flawed approaches at these organizations are more likely to have adverse effects on the broader financial system. The Federal Reserve will work with LCBOs as necessary through the supervisory process to ensure that they promptly correct any deficiencies that may be inconsistent with the safety and soundness of the organization.

The policies, procedures, and systems of smaller banking organizations that use incentive compensation arrangements<sup>7</sup> are expected to be less extensive, formalized, and detailed than those of LCBOs. Supervisory reviews of incentive compensation arrangements at smaller, less-complex banking organizations will be conducted by the Federal Reserve as part of the evaluation of those organizations' risk-management, internal controls, and corporate governance during the regular, risk-focused examination process. These reviews will be tailored to reflect the scope and complexity of an organization's activities, as well as the prevalence and scope of its incentive compensation arrangements. Little, if any, additional examination work is expected for smaller banking organizations that do not use, to a significant extent, incentive compensation arrangements.<sup>8</sup>

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5. In December 2009, the Federal Reserve, working with the other Agencies, initiated a special horizontal review of incentive compensation arrangements and related risk-management, control, and corporate governance practices of large banking organizations (LBOs). This initiative was designed to spur and monitor the industry's progress towards the implementation of safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry.

6. For supervisory purposes, the Federal Reserve (as well as the other federal bank regulatory agencies) segments the organizations it supervises into different supervisory portfolios based on, among other things, size, complexity, and risk profile. For purposes of this guidance, the LBOs referred to in the guidance are identified in this section as large complex banking organizations to be consistent with the Federal Reserve's other supervisory policies. LBOs are designated by (1) the OCC as the largest and most complex national banks

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as defined in the Large Bank Supervision booklet of the Comptroller's Handbook; (2) the FDIC, large, complex insured depository institutions (IDIs); and (3) the OTS, the largest and most complex savings associations and savings and loan holding companies.

7. This guidance does not apply to banking organizations that do not use incentive compensation.

8. To facilitate these reviews, where appropriate, a smaller banking organization should review its compensation arrangements to determine whether it uses incentive compensation arrangements to a significant extent in its business operations. A smaller banking organization will not be considered a significant user of incentive compensation arrangements simply because the organization has a firm-wide profit-sharing or

For all banking organizations, supervisory findings related to incentive compensation will be communicated to the organization and included in the relevant report of examination or inspection. In addition, these findings will be incorporated, as appropriate, into the organization's rating component(s) and subcomponent(s) relating to risk-management, internal controls, and corporate governance under the relevant supervisory rating system, as well as the organization's overall supervisory rating.

The Federal Reserve (or the organization's appropriate federal supervisor) may take enforcement action against a banking organization if its incentive compensation arrangements or related risk-management, control, or governance processes pose a risk to the safety and soundness of the organization, particularly when the organization is not taking prompt and effective measures to correct the deficiencies. For example, the appropriate federal supervisor may take an enforcement action if material deficiencies are found to exist in the organization's incentive compensation arrangements or related risk-management, control, or governance processes, or the organization fails to promptly develop, submit, or adhere to an effective plan designed to ensure that its incentive compensation arrangements do not encourage imprudent risk-taking and are consistent with principles of safety and soundness. As provided under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), an enforcement action may, among other things, require an organization to take affirmative action, such as developing a corrective action plan that is acceptable to the appropriate federal supervisor to rectify safety-and-soundness deficiencies in its incentive compensation arrangements or related processes. Where warranted, the appropriate federal supervisor may require the organization to take additional affirmative action to correct or remedy deficiencies related to the organization's incentive compensation practices.

Effective and balanced incentive compensation practices are likely to evolve significantly in the coming years, spurred by the efforts of banking organizations, supervisors, and other stakeholders. The Federal Reserve will review and update this guidance as appropriate to incorporate best practices that emerge from these efforts.

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bonus plan that is based on the bank's profitability, even if the plan covers all or most of the organization's employees.

## SCOPE OF APPLICATION

The incentive compensation arrangements and related policies and procedures of banking organizations should be consistent with principles of safety and soundness.<sup>9</sup> Incentive compensation arrangements for executive officers as well as for non-executive personnel who have the ability to expose a banking organization to material amounts of risk may, if not properly structured, pose a threat to the organization's safety and soundness. Accordingly, this guidance applies to incentive compensation arrangements for:

1. Senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;<sup>10</sup>
2. Individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk (e.g., traders with large position limits relative to the organization's overall risk tolerance); and
3. Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).

For ease of reference, these executive and non-executive employees are collectively referred to hereafter as "covered employees" or "employees." Depending on the facts and circumstances of the individual organization, the

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9. In the case of the U.S. operations of FBOs, the organization's policies, including management, review, and approval requirements for its U.S. operations, should be coordinated with the FBO's group-wide policies developed in accordance with the rules of the FBO's home country supervisor. The policies of the FBO's U.S. operations should also be consistent with the FBO's overall corporate and management structure, as well as its framework for risk-management and internal controls. In addition, the policies for the U.S. operations of FBOs should be consistent with this guidance.

10. Senior executives include, at a minimum, "executive officers" within the meaning of the Federal Reserve's Regulation O (see 12 CFR 215.2(e)(1)) and, for publicly traded companies, "named officers" within the meaning of the Securities and Exchange Commission's rules on disclosure of executive compensation (see 17 CFR 229.402(a)(3)). Savings associations should also refer to the OTS's rule on loans by savings associations to their executive officers, directors, and principal shareholders. (12 CFR 563.43).

types of employees or categories of employees that are outside the scope of this guidance because they do not have the ability to expose the organization to material risks would likely include, for example, tellers, bookkeepers, couriers, or data processing personnel.

In determining whether an employee, or group of employees, may expose a banking organization to material risk, the organization should consider the full range of inherent risks arising from, or generated by, the employee's activities, even if the organization uses risk-management processes or controls to limit the risks such activities ultimately may pose to the organization. Moreover, risks should be considered to be material for purposes of this guidance if they are material to the organization, or are material to a business line or operating unit that is itself material to the organization.<sup>11</sup>

For purposes of illustration, assume that a banking organization has a structured-finance unit that is material to the organization. A group of employees within that unit who originate structured-finance transactions that may expose the unit to material risks should be considered "covered employees" for purposes of this guidance even if those transactions must be approved by an independent risk function prior to consummation, or the organization uses other processes or methods to limit the risk that such transactions may present to the organization.

Strong and effective risk-management and internal control functions are critical to the safety and soundness of banking organizations. However, irrespective of the quality of these functions, poorly designed or managed incentive compensation arrangements can themselves be a source of risk to a banking organization. For example, incentive compensation arrangements that provide employees strong incentives to increase the organization's short-term revenues or profits, without regard to the short- or long-term risk associated with such business, can place substantial strain on the risk-management and internal control functions of even well-managed organizations.

Moreover, poorly balanced incentive compensation arrangements can encourage employees to take affirmative actions to weaken or circumvent the organization's risk-management or internal control functions, such as by providing

inaccurate or incomplete information to these functions, to boost the employee's personal compensation. Accordingly, sound compensation practices are an integral part of strong risk-management and internal control functions. A key goal of this guidance is to encourage banking organizations to incorporate the risks related to incentive compensation into their broader risk-management framework. Risk-management procedures and risk controls that ordinarily limit risk-taking do not obviate the need for incentive compensation arrangements to properly balance risk-taking incentives.

## PRINCIPLES OF A SOUND INCENTIVE COMPENSATION SYSTEM

### Principle 1: Balanced Risk-Taking Incentives

*Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks.*

Incentive compensation arrangements typically attempt to encourage actions that result in greater revenue or profit for the organization. However, short-run revenue or profit can often diverge sharply from actual long-run profit because risk outcomes may become clear only over time. Activities that carry higher risk typically yield higher short-term revenue, and an employee who is given incentives to increase short-term revenue or profit, without regard to risk, will naturally be attracted to opportunities to expose the organization to more risk.

An incentive compensation arrangement is balanced when the amounts paid to an employee appropriately take into account the risks (including compliance risks), as well as the financial benefits, from the employee's activities and the impact of those activities on the organization's safety and soundness. As an example, under a balanced incentive compensation arrangement, two employees who generate the same amount of short-term revenue or profit for an organization should not receive the same amount of incentive compensation if the risks taken by the employees in generating that revenue or profit differ materially. The employee whose activities create materially larger risks for the organiza-

11. Thus, risks may be material to an organization even if they are not large enough themselves to threaten the solvency of the organization.

tion should receive less than the other employee, all else being equal.

The performance measures used in an incentive compensation arrangement have an important effect on the incentives provided employees and, thus, the potential for the arrangement to encourage imprudent risk-taking. For example, if an employee's incentive compensation payments are closely tied to short-term revenue or profit of business generated by the employee, without any adjustments for the risks associated with the business generated, the potential for the arrangement to encourage imprudent risk-taking may be quite strong. Similarly, traders who work with positions that close at year-end could have an incentive to take large risks toward the end of a year if there is no mechanism for factoring how such positions perform over a longer period of time. The same result could ensue if the performance measures themselves lack integrity or can be manipulated inappropriately by the employees receiving incentive compensation.

On the other hand, if an employee's incentive compensation payments are determined based on performance measures that are only distantly linked to the employee's activities (e.g., for most employees, organization-wide profit), the potential for the arrangement to encourage the employee to take imprudent risks on behalf of the organization may be weak. For this reason, plans that provide for awards based solely on overall organization-wide performance are unlikely to provide employees, other than senior executives and individuals who have the ability to materially affect the organization's overall risk profile, with unbalanced risk-taking incentives.

Incentive compensation arrangements should not only be balanced in design, they also should be implemented so that actual payments vary based on risks or risk outcomes. If, for example, employees are paid substantially all of their potential incentive compensation even when risk or risk outcomes are materially worse than expected, employees have less incentive to avoid activities with substantial risk.

- *Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized, in assessing whether incentive compensation arrangements are balanced.*

The activities of employees may create a wide range of risks for a banking organization, such as credit, market, liquidity, operational, legal, compliance, and reputational risks, as well as other risks to the viability or operation of the organization. Some of these risks may be realized in the short term, while others may become apparent only over the long term. For example, future revenues that are booked as current income may not materialize, and short-term profit-and-loss measures may not appropriately reflect differences in the risks associated with the revenue derived from different activities (e.g., the higher credit or compliance risk associated with subprime loans versus prime loans).<sup>12</sup> In addition, some risks (or combinations of risky strategies and positions) may have a low probability of being realized, but would have highly adverse effects on the organization if they were to be realized ("bad tail risks"). While shareholders may have less incentive to guard against bad tail risks because of the infrequency of their realization and the existence of the federal safety net, these risks warrant special attention for safety-and-soundness reasons given the threat they pose to the organization's solvency and the federal safety net.

Banking organizations should consider the full range of current and potential risks associated with the activities of covered employees, including the cost and amount of capital and liquidity needed to support those risks, in developing balanced incentive compensation arrangements. Reliable quantitative measures of risk and risk outcomes ("quantitative measures"), where available, may be particularly useful in developing balanced compensation arrangements and in assessing the extent to which arrangements are properly balanced. However, reliable quantitative measures may not be available for all types of risk or for all activities, and their utility for use in compensation arrangements varies across business lines and employees. The absence of reliable quantitative measures for certain types of risks or outcomes does not mean that banking organizations should ignore such risks or outcomes for purposes of assessing whether an incentive compensation

12. Importantly, the time horizon over which a risk outcome may be realized is not necessarily the same as the stated maturity of an exposure. For example, the ongoing reinvestment of funds by a cash management unit in commercial paper with a one-day maturity not only exposes the organization to one-day credit risk, but also exposes the organization to liquidity risk that may be realized only infrequently.



arrangement achieves balance. For example, while reliable quantitative measures may not exist for many bad-tail risks, it is important that such risks be considered given their potential effect on safety and soundness. As in other risk-management areas, banking organizations should rely on informed judgments, supported by available data, to estimate risks and risk outcomes in the absence of reliable quantitative risk measures.

*Large complex banking organizations.* In designing and modifying incentive compensation arrangements, LCBOs should assess in advance of implementation whether such arrangements are likely to provide balanced risk-taking incentives. Simulation analysis of incentive compensation arrangements is one way of doing so. Such analysis uses forward-looking projections of incentive compensation awards and payments based on a range of performance levels, risk outcomes, and levels of risks taken. This type of analysis, or other analysis that results in assessments of likely effectiveness, can help an LCBO assess whether incentive compensation awards and payments to an employee are likely to be reduced appropriately as the risks to the organization from the employee's activities increase.

- *An unbalanced arrangement can be moved toward balance by adding or modifying features that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes.*

If an incentive compensation arrangement may encourage employees to expose their banking organization to imprudent risks, the organization should modify the arrangement as needed to ensure that it is consistent with safety and soundness. Four methods are often used to make compensation more sensitive to risk. These methods are:

1. *Risk Adjustment of Awards:* The amount of an incentive compensation award for an employee is adjusted based on measures that take into account the risk the employee's activities may pose to the organization. Such measures may be quantitative, or the size of a risk adjustment may be set judgmentally, subject to appropriate oversight.
2. *Deferral of Payment:* The actual payout of an

award to an employee is delayed significantly beyond the end of the performance period, and the amounts paid are adjusted for actual losses or other aspects of performance that are realized or become better known only during the deferral period.<sup>13</sup> Deferred payouts may be altered according to risk outcomes either formulaically or judgmentally, subject to appropriate oversight. To be most effective, the deferral period should be sufficiently long to allow for the realization of a substantial portion of the risks from employee activities, and the measures of loss should be clearly explained to employees and closely tied to their activities during the relevant performance period.

3. *Longer Performance Periods:* The time period covered by the performance measures used in determining an employee's award is extended (for example, from one year to two or more years). Longer performance periods and deferral of payment are related in that both methods allow awards or payments to be made after some or all risk outcomes are realized or better known.
4. *Reduced Sensitivity to Short-Term Performance:* The banking organization reduces the rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s). Rather than offsetting risk-taking incentives associated with the use of short-term performance measures, this method reduces the magnitude of such incentives. This method also can include improving the quality and reliability of performance measures in taking into account both short-term and long-term risks, for example improving the reliability and accuracy of estimates of revenues and long-term profits upon which performance measures depend.<sup>14</sup>

13. The deferral-of-payment method is sometimes referred to in the industry as a "clawback." The term "clawback" also may refer specifically to an arrangement under which an employee must return incentive compensation payments previously received by the employee (and not just deferred) if certain risk outcomes occur. Section 304 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7243), which applies to chief executive officers and chief financial officers of public banking organizations, is an example of this more specific type of "clawback" requirement.

14. Performance targets may have a material effect on risk-taking incentives. Such targets may offer employees greater rewards for increments of performance that are above the target or may provide that awards will be granted only if

These methods for achieving balance are not exclusive, and additional methods or variations may exist or be developed. Moreover, each method has its own advantages and disadvantages. For example, where reliable risk measures exist, risk adjustment of awards may be more effective than deferral of payment in reducing incentives for imprudent risk-taking. This is because risk adjustment potentially can take account of the full range and time horizon of risks, rather than just those risk outcomes that occur or become more evident during the deferral period. On the other hand, deferral of payment may be more effective than risk adjustment in mitigating incentives to take hard-to-measure risks (such as the risks of new activities or products, or certain risks such as reputational or operational risk that may be difficult to measure with respect to particular activities), especially if such risks are likely to be realized during the deferral period. Accordingly, in some cases two or more methods may be needed in combination for an incentive compensation arrangement to be balanced.

The greater the potential incentives an arrangement creates for an employee to increase the risks associated with the employee's activities, the stronger the effect should be of the methods applied to achieve balance. Thus, for example, risk adjustments used to counteract a materially unbalanced compensation arrangement should have a similarly material impact on the incentive compensation paid under the arrangement. Further, improvements in the quality and reliability of performance measures themselves, for example, improving the reliability and accuracy of estimates of revenues and profits upon which performance measures depend, can significantly improve the degree of balance in risk-taking incentives.

Where judgment plays a significant role in the design or operation of an incentive compensation arrangement, strong policies and procedures, internal controls, and ex post monitoring of incentive compensation payments relative to actual risk outcomes are particularly important to help ensure that the arrangements as implemented are balanced and do not encourage imprudent risk-taking. For example, if a banking organization relies to a significant degree on the judgment of one or more managers to ensure

that the incentive compensation awards to employees are appropriately risk-adjusted, the organization should have policies and procedures that describe how managers are expected to exercise that judgment to achieve balance and that provide for the manager(s) to receive appropriate available information about the employee's risk-taking activities to make informed judgments.

*Large complex banking organizations.* Methods and practices for making compensation sensitive to risk are likely to evolve rapidly during the next few years, driven in part by the efforts of supervisors and other stakeholders. LCBOs should actively monitor developments in the field and should incorporate into their incentive compensation systems new or emerging methods or practices that are likely to improve the organization's long-term financial well-being and safety and soundness.

- *The manner in which a banking organization seeks to achieve balanced incentive compensation arrangements should be tailored to account for the differences between employees—including the substantial differences between senior executives and other employees—as well as between banking organizations.*

Activities and risks may vary significantly both across banking organizations and across employees within a particular banking organization. For example, activities, risks, and incentive compensation practices may differ materially among banking organizations based on, among other things, the scope or complexity of activities conducted and the business strategies pursued by the organizations. These differences mean that methods for achieving balanced compensation arrangements at one organization may not be effective in restraining incentives to engage in imprudent risk-taking at another organization. Each organization is responsible for ensuring that its incentive compensation arrangements are consistent with the safety and soundness of the organization.

Moreover, the risks associated with the activities of one group of non-executive employees (e.g., loan originators) within a banking organization may differ significantly from those of another group of non-executive employees (e.g., spot foreign exchange traders) within the organization. In addition, reliable quantitative mea-

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a target is met or exceeded. Employees may be particularly motivated to take imprudent risk in order to reach performance targets that are aggressive but potentially achievable.

asures of risk and risk outcomes are unlikely to be available for a banking organization as a whole, particularly a large, complex organization. This factor can make it difficult for banking organizations to achieve balanced compensation arrangements for senior executives who have responsibility for managing risks on an organization-wide basis solely through use of the risk-adjustment-of-award method.

Furthermore, the payment of deferred incentive compensation in equity (such as restricted stock of the organization) or equity-based instruments (such as options to acquire the organization's stock) may be helpful in restraining the risk-taking incentives of senior executives and other covered employees whose activities may have a material effect on the overall financial performance of the organization. However, equity-related deferred compensation may not be as effective in restraining the incentives of lower-level covered employees (particularly at large organizations) to take risks because such employees are unlikely to believe that their actions will materially affect the organization's stock price.

Banking organizations should take account of these differences when constructing balanced compensation arrangements. For most banking organizations, the use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to result in arrangements that are unbalanced at least with respect to some employees.<sup>15</sup>

*Large complex banking organizations.* Incentive compensation arrangements for senior executives at LCBOs are likely to be better balanced if they involve deferral of a substantial portion of the executives' incentive compensation over a multi-year period in a way that reduces the amount received in the event of poor performance, substantial use of multi-year performance periods, or both. Similarly, the compensation arrangements for senior executives at LCBOs are likely to be better balanced if a significant portion of the incentive compensation of these executives is paid in the form of

equity-based instruments that vest over multiple years, with the number of instruments ultimately received dependent on the performance of the organization during the deferral period.

The portion of the incentive compensation of other covered employees that is deferred or paid in the form of equity-based instruments should appropriately take into account the level, nature, and duration of the risks that the employees' activities create for the organization and the extent to which those activities may materially affect the overall performance of the organization and its stock price. Deferral of a substantial portion of an employee's incentive compensation may not be workable for employees at lower pay scales because of their more limited financial resources. This may require increased reliance on other measures in the incentive compensation arrangements for these employees to achieve balance.

- *Banking organizations should carefully consider the potential for "golden parachutes" and the vesting arrangements for deferred compensation to affect the risk-taking behavior of employees while at the organizations.*

Arrangements that provide for an employee (typically a senior executive), upon departure from the organization or a change in control of the organization, to receive large additional payments or the accelerated payment of deferred amounts without regard to risk or risk outcomes can provide the employee significant incentives to expose the organization to undue risk. For example, an arrangement that provides an employee with a guaranteed payout upon departure from an organization, regardless of performance, may neutralize the effect of any balancing features included in the arrangement to help prevent imprudent risk-taking.

Banking organizations should carefully review any such existing or proposed arrangements (sometimes called "golden parachutes") and the potential impact of such arrangements on the organization's safety and soundness. In appropriate circumstances an organization should consider including balancing features—such as risk adjustment or deferral requirements that extend past the employee's departure—in the arrangements to mitigate the potential for the arrangements to encourage imprudent risk-taking. In all cases, a banking organization should ensure that the structure and terms of any golden parachute arrangement entered into by the organization do

15. For example, spreading payouts of incentive compensation awards over a standard three-year period may not appropriately reflect the differences in the type and time horizon of risk associated with the activities of different groups of employees, and may not be sufficient by itself to balance the compensation arrangements of employees who may expose the organization to substantial longer-term risks.

not encourage imprudent risk-taking in light of the other features of the employee's incentive compensation arrangements.

*Large complex banking organizations.* Provisions that require a departing employee to forfeit deferred incentive compensation payments may weaken the effectiveness of the deferral arrangement if the departing employee is able to negotiate a "golden handshake" arrangement with the new employer.<sup>16</sup> This weakening effect can be particularly significant for senior executives or other skilled employees at LCBOs whose services are in high demand within the market.

Golden handshake arrangements present special issues for LCBOs and supervisors. For example, while a banking organization could adjust its deferral arrangements so that departing employees will continue to receive any accrued deferred compensation after departure (subject to any clawback or malus<sup>17</sup>), these changes could (1) reduce the employee's incentive to remain at the organization and, thus, weaken an organization's ability to retain qualified talent, which is an important goal of compensation, and (2) create conflicts of interest. Moreover, actions of the hiring organization (which may or may not be a supervised banking organization) ultimately may defeat these or other risk-balancing aspects of a banking organization's deferral arrangements. LCBOs should monitor whether golden handshake arrangements are materially weakening the organization's efforts to constrain the risk-taking incentives of employees. The Federal Reserve will continue to work with banking organizations and others to develop appropriate methods for addressing any effect that such arrangements may have on the safety and soundness of banking organizations.

- *Banking organizations should effectively communicate to employees the ways in which incentive compensation awards and payments*

16. Golden handshakes are arrangements that compensate an employee for some or all of the estimated, non-adjusted value of deferred incentive compensation that would have been forfeited upon departure from the employee's previous employment.

17. A malus arrangement permits the employer to prevent vesting of all or part of the amount of a deferred remuneration award. Malus provisions are invoked when risk outcomes are worse than expected or when the information upon which the award was based turns out to have been incorrect. Loss of unvested compensation due to the employee voluntarily leaving the firm is not an example of malus as the term is used in this guidance.

*will be reduced as risks increase.*

In order for the risk-sensitive provisions of incentive compensation arrangements to affect employee risk-taking behavior, the organization's employees need to understand that the amount of incentive compensation that they may receive will vary based on the risk associated with their activities. Accordingly, banking organizations should ensure that employees covered by an incentive compensation arrangement are informed about the key ways in which risks are taken into account in determining the amount of incentive compensation paid. Where feasible, an organization's communications with employees should include examples of how incentive compensation payments may be adjusted to reflect projected or actual risk outcomes. An organization's communications should be tailored appropriately to reflect the sophistication of the relevant audience(s).

## Principle 2: Compatibility with Effective Controls and Risk-Management

*A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.*

In order to increase their own compensation, employees may seek to evade the processes established by a banking organization to achieve balanced compensation arrangements. Similarly, an employee covered by an incentive compensation arrangement may seek to influence, in ways designed to increase the employee's pay, the risk measures or other information or judgments that are used to make the employee's pay sensitive to risk.

Such actions may significantly weaken the effectiveness of an organization's incentive compensation arrangements in restricting imprudent risk-taking. These actions can have a particularly damaging effect on the safety and soundness of the organization if they result in the weakening of risk measures, information, or judgments that the organization uses for other risk-management, internal control, or financial purposes. In such cases, the employee's actions may weaken not only the balance of the orga-

nization's incentive compensation arrangements, but also the risk-management, internal controls, and other functions that are supposed to act as a separate check on risk-taking. For this reason, traditional risk-management controls alone do not eliminate the need to identify employees who may expose the organization to material risk, nor do they obviate the need for the incentive compensation arrangements for these employees to be balanced. Rather, a banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

- *Banking organizations should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk-management and other functions.*

To help prevent damage from occurring, a banking organization should have strong controls governing its process for designing, implementing, and monitoring incentive compensation arrangements. Banking organizations should create and maintain sufficient documentation to permit an audit of the effectiveness of the organization's processes for establishing, modifying, and monitoring incentive compensation arrangements. Smaller banking organizations should incorporate reviews of these processes into their overall framework for compliance monitoring (including internal audit).

*Large complex banking organizations.* LCBOs should have and maintain policies and procedures that (1) identify and describe the role(s) of the personnel, business units, and control units authorized to be involved in the design, implementation, and monitoring of incentive compensation arrangements; (2) identify the source of significant risk-related inputs into these processes and establish appropriate controls governing the development and approval of these inputs to help ensure their integrity; and (3) identify the individual(s) and control unit(s) whose approval is necessary for the establishment of new incentive compensation arrangements or modification of existing arrangements.

An LCBO also should conduct regular internal reviews to ensure that its processes for achieving and maintaining balanced incentive compensation arrangements are consistently fol-

lowed. Such reviews should be conducted by audit, compliance, or other personnel in a manner consistent with the organization's overall framework for compliance monitoring. An LCBO's internal audit department also should separately conduct regular audits of the organization's compliance with its established policies and controls relating to incentive compensation arrangements. The results should be reported to appropriate levels of management and, where appropriate, the organization's board of directors.

- *Appropriate personnel, including risk-management personnel, should have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining imprudent risk-taking.*

Developing incentive compensation arrangements that provide balanced risk-taking incentives and monitoring arrangements to ensure they achieve balance over time requires an understanding of the risks (including compliance risks) and potential risk outcomes associated with the activities of the relevant employees. Accordingly, banking organizations should have policies and procedures that ensure that risk-management personnel have an appropriate role in the organization's processes for designing incentive compensation arrangements and for assessing their effectiveness in restraining imprudent risk-taking.<sup>18</sup> Ways that risk managers might assist in achieving balanced compensation arrangements include, but are not limited to

1. reviewing the types of risks associated with the activities of covered employees;
2. approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred-payout arrangements; and
3. analyzing risk-taking and risk outcomes relative to incentive compensation payments.

Other functions within an organization, such as its control, human resources, or finance functions, also play an important role in helping

<sup>18</sup> Involvement of risk-management personnel in the design and monitoring of these arrangements also should help ensure that the organization's risk-management functions can properly understand and address the full range of risks facing the organization.

ensure that incentive compensation arrangements are balanced. For example, these functions may contribute to the design and review of performance measures used in compensation arrangements or may supply data used as part of these measures.

- *Compensation for employees in risk-management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.*

The risk-management and control personnel involved in the design, oversight, and operation of incentive compensation arrangements should have appropriate skills and experience needed to effectively fulfill their roles. These skills and experiences should be sufficient to equip the personnel to remain effective in the face of challenges by covered employees seeking to increase their incentive compensation in ways that are inconsistent with sound risk-management or internal controls. The compensation arrangements for employees in risk-management and control functions thus should be sufficient to attract and retain qualified personnel with experience and expertise in these fields that is appropriate in light of the size, activities, and complexity of the organization.

In addition, to help preserve the independence of their perspectives, the incentive compensation received by risk-management and control personnel staff should not be based substantially on the financial performance of the business units that they review. Rather, the performance measures used in the incentive compensation arrangements for these personnel should be based primarily on the achievement of the objectives of their functions (e.g., adherence to internal controls).

- *Banking organizations should monitor the performance of their incentive compensation arrangements and should revise the arrangements as needed if payments do not appropriately reflect risk.*

Banking organizations should monitor incentive compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive compensation payments to employees are reduced to reflect adverse risk outcomes or high levels of risk taken. Results should be reported to appropriate levels of

management, including the board of directors where warranted and consistent with Principle 3 below. The monitoring methods and processes used by a banking organization should be commensurate with the size and complexity of the organization, as well as its use of incentive compensation. Thus, for example, a small, noncomplex organization that uses incentive compensation only to a limited extent may find that it can appropriately monitor its arrangements through normal management processes.

A banking organization should take the results of such monitoring into account in establishing or modifying incentive compensation arrangements and in overseeing associated controls. If, over time, incentive compensation paid by a banking organization does not appropriately reflect risk outcomes, the organization should review and revise its incentive compensation arrangements and related controls to ensure that the arrangements, as designed and implemented, are balanced and do not provide employees incentives to take imprudent risks.

### Principle 3: Strong Corporate Governance

*Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors.*

Given the key role of senior executives in managing the overall risk-taking activities of an organization, the board of directors of a banking organization should directly approve the incentive compensation arrangements for senior executives.<sup>19</sup> The board also should approve and document any material exceptions or adjustments to the incentive compensation arrangements established for senior executives and should carefully consider and monitor the effects

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19. As used in this guidance, the term “board of directors” is used to refer to the members of the board of directors who have primary responsibility for overseeing the incentive compensation system. Depending on the manner in which the board is organized, the term may refer to the entire board of directors, a compensation committee of the board, or another committee of the board that has primary responsibility for overseeing the incentive compensation system. In the case of FBOs, the term refers to the relevant oversight body for the firm’s U.S. operations, consistent with the FBO’s overall corporate and management structure.

of any approved exceptions or adjustments on the balance of the arrangement, the risk-taking incentives of the senior executive, and the safety and soundness of the organization.

The board of directors of an organization also is ultimately responsible for ensuring that the organization's incentive compensation arrangements for all covered employees are appropriately balanced and do not jeopardize the safety and soundness of the organization. The involvement of the board of directors in oversight of the organization's overall incentive compensation program should be scaled appropriately to the scope and prevalence of the organization's incentive compensation arrangements.

*Large complex banking organizations and organizations that are significant users of incentive compensation.* The board of directors of an LCBO or other banking organization that uses incentive compensation to a significant extent should actively oversee the development and operation of the organization's incentive compensation policies, systems, and related control processes. The board of directors of such an organization should review and approve the overall goals and purposes of the organization's incentive compensation system. In addition, the board should provide clear direction to management to ensure that the goals and policies it establishes are carried out in a manner that achieves balance and is consistent with safety and soundness.

The board of directors of such an organization also should ensure that steps are taken so that the incentive compensation system—including performance measures and targets—is designed and operated in a manner that will achieve balance.

- *The board of directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements.*

To allow for informed reviews, the board should receive data and analysis from management or other sources that are sufficient to allow the board to assess whether the overall design and performance of the organization's incentive compensation arrangements are consistent with the organization's safety and soundness. These reviews and reports should be appropriately scoped to reflect the size and complexity of the banking organization's activities and the preva-

lence and scope of its incentive compensation arrangements.

The board of directors of a banking organization should closely monitor incentive compensation payments to senior executives and the sensitivity of those payments to risk outcomes. In addition, if the compensation arrangement for a senior executive includes a clawback provision, then the review should include sufficient information to determine if the provision has been triggered and executed as planned.

The board of directors of a banking organization should seek to stay abreast of significant emerging changes in compensation plan mechanisms and incentives in the marketplace as well as developments in academic research and regulatory advice regarding incentive compensation policies. However, the board should recognize that organizations, activities, and practices within the industry are not identical. Incentive compensation arrangements at one organization may not be suitable for use at another organization because of differences in the risks, controls, structure, and management among organizations. The board of directors of each organization is responsible for ensuring that the incentive compensation arrangements for its organization do not encourage employees to take risks that are beyond the organization's ability to manage effectively, regardless of the practices employed by other organizations.

*Large complex banking organizations and organizations that are significant users of incentive compensation.* The board of an LCBO or other organization that uses incentive compensation to a significant extent should receive and review, on an annual or more frequent basis, an assessment by management, with appropriate input from risk-management personnel, of the effectiveness of the design and operation of the organization's incentive compensation system in providing risk-taking incentives that are consistent with the organization's safety and soundness. These reports should include an evaluation of whether or how incentive compensation practices may increase the potential for imprudent risk-taking.

The board of such an organization also should receive periodic reports that review incentive compensation awards and payments relative to risk outcomes on a backward-looking basis to determine whether the organization's incentive compensation arrangements may be promoting imprudent risk-taking. Boards of directors of

these organizations also should consider periodically obtaining and reviewing simulation analysis of compensation on a forward-looking basis based on a range of performance levels, risk outcomes, and the amount of risks taken.

- *The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation.*

The board of directors of a banking organization should have, or have access to, a level of expertise and experience in risk-management and compensation practices in the financial services industry that is appropriate for the nature, scope, and complexity of the organization's activities. This level of expertise may be present collectively among the members of the board, may come from formal training or from experience in addressing these issues, including as a director, or may be obtained through advice received from outside counsel, consultants, or other experts with expertise in incentive compensation and risk-management. The board of directors of an organization with less complex and extensive incentive compensation arrangements may not find it necessary or appropriate to require special board expertise or to retain and use outside experts in this area.

In selecting and using outside parties, the board of directors should give due attention to potential conflicts of interest arising from other dealings of the parties with the organization or for other reasons. The board also should exercise caution to avoid allowing outside parties to obtain undue levels of influence. While the retention and use of outside parties may be helpful, the board retains ultimate responsibility for ensuring that the organization's incentive compensation arrangements are consistent with safety and soundness.

*Large complex banking organizations and organizations that are significant users of incentive compensation.* If a separate compensation committee is not already in place or required by other authorities,<sup>20</sup> the board of directors of an LCBO or other banking organization that uses incentive compensation to a significant extent should consider establishing such a committee—reporting to the full board—that has primary

20. See New York Stock Exchange Listed Company Manual Section 303A.05(a); Nasdaq Listing Rule 5605(d); Internal Revenue Code section 162(m) (26 U.S.C. 162(m)).

responsibility for overseeing the organization's incentive compensation systems. A compensation committee should be composed solely or predominantly of non-executive directors. If the board does not have such a compensation committee, the board should take other steps to ensure that non-executive directors of the board are actively involved in the oversight of incentive compensation systems. The compensation committee should work closely with any board-level risk and audit committees where the substance of their actions overlap.

- *A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.*

If a banking organization's incentive compensation arrangements provide employees incentives to take risks that are beyond the tolerance of the organization's shareholders, these risks are likely to also present a risk to the safety and soundness of the organization.<sup>21</sup> To help promote safety and soundness, a banking organization should provide an appropriate amount of information concerning its incentive compensation arrangements for executive and non-executive employees and related risk-management, control, and governance processes to shareholders to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes that encourage employees to take imprudent risks. Such disclosures should include information relevant to employees other than senior executives. The scope and level of the information disclosed by the organization should be tailored to the nature and complexity of the organization and its incentive compensation arrangements.<sup>22</sup>

- *Large complex banking organizations should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements.*

21. On the other hand, as noted previously, compensation arrangements that are in the interests of the shareholders of a banking organization are not necessarily consistent with safety and soundness.

22. A banking organization also should comply with the incentive compensation disclosure requirements of the federal securities law and other laws as applicable. See, for example, Proxy Disclosure Enhancements, SEC Release Nos. 33-9089, 34-61175, 74 F.R. 68334 (Dec. 23, 2009) (to be codified at 17 C.F.R. 229 and 249).



At banking organizations with large numbers of risk-taking employees engaged in diverse activities, an ad hoc approach to developing balanced arrangements is unlikely to be reliable. Thus, an LCBO should use a systematic approach—supported by robust and formalized policies, procedures, and systems—to ensure that those arrangements are appropriately balanced and consistent with safety and soundness. Such an approach should provide for the organization effectively to:

1. Identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks. These employees should include
  - a. senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;
  - b. individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk; and
  - c. groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk;
2. Identify the types and time horizons of risks to the organization from the activities of these employees;
3. Assess the potential for the performance measures included in the incentive compensation arrangements for these employees, those that encourage employees to take imprudent risks;
4. Include balancing elements (such as risk adjustments or deferral periods) within the incentive compensation arrangements for these employees, that are reasonably designed

to ensure that the arrangement will be balanced in light of the size, type, and time horizon of the inherent risks of the employees' activities;

5. Communicate to the employees the ways in which their incentive compensation awards or payments will be adjusted to reflect the risks of their activities to the organization; and
6. Monitor incentive compensation awards, payments, risks taken, and risk outcomes for these employees and modify the relevant arrangements if payments made are not appropriately sensitive to risk and risk outcomes.

## CONCLUSION ON SOUND INCENTIVE COMPENSATION

Banking organizations are responsible for ensuring that their incentive compensation arrangements do not encourage imprudent risk-taking behavior and are consistent with the safety and soundness of the organization. The Federal Reserve expects banking organizations to take prompt action to address deficiencies in their incentive compensation arrangements or related risk-management, control, and governance processes.

The Federal Reserve intends to actively monitor the actions taken by banking organizations in this area and will promote further advances in designing and implementing balanced incentive compensation arrangements. Where appropriate, the Federal Reserve will take supervisory or enforcement action to ensure that material deficiencies that pose a threat to the safety and soundness of the organization are promptly addressed. The Federal Reserve also will update this guidance as appropriate to incorporate best practices as they develop over time.

### INTRODUCTION

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

### GENERAL EXAMINATION APPROACH

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

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

If internal or external auditors have not performed adequate audit procedures relating to income and expenses, the examiner should test check computations for accuracy and trace entries to appropriate accounts. (See "Internal

Control," section 1010, for a discussion of procedures to use in reviewing the audit work of others.)

### ANALYTICAL REVIEW

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

### Analytical Tools

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

### *Review of Financial Statements*

An analytical review of a bank's financial statements requires professional judgment and an

inquiring attitude. During the analysis, the examiner should avoid details not specifically related to his or her objective so that excessive time is not spent analyzing relatively immaterial amounts.

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

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

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

### *UBPR*

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

the income stream and its possible future variability.

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

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

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

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

may detect an upward trend in yields for a specific category of loans. That upward trend might be partially or wholly offset by a downward trend of yields in another category of loans, and the examiner should consider further investigating the circumstances applicable to each of those loan categories. A change in yields could be a result of a change in the bank's "appetite" for certain types of loans or may indicate a change in loan underwriting standards.); or

- income or expense resulting from a change in the bank's operations, such as the opening of a new branch or starting of a mortgage banking activity or trust department, may skew performance ratios. (When there has been a significant change in a bank's operations, the examiner should analyze the potential impact of the change on future bank earnings.)

## Written Analysis

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

- quality and future prospects for core income;
- ability to cover losses and maintain adequate capital, including compliance with the minimum capital standard;
- earnings levels and trends;
- composition of earnings and sustainability of

the various earnings components (This may include a discussion of balance-sheet composition, particularly the volume and type of earning assets and off-balance-sheet items, if applicable.);

- peer-group comparisons;
- vulnerability to interest-rate and other market or price risks;
- income and expense accounts, and their reliability, including applicable accounting practices, internal controls, and audit methods;
- compliance with laws and regulations relating to earnings and dividends; and
- budgeting process and the levels of management involved in it.

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

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

# Analytical Review and Income and Expense Examination Objectives

Effective date May 1996

## Section 4010.2

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

# Analytical Review and Income and Expense Examination Procedures

Effective date March 1984

## Section 4010.3

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

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

# Analytical Review and Income and Expense Internal Control Questionnaire

Effective date March 1984

## Section 4010.4

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

### GENERAL

1. Does the bank have a budget? If so:
  - a. Is it reviewed and approved by managerial personnel and/or the board of directors?
  - b. Is it periodically reviewed and updated for changed conditions?
  - c. Are periodic statements compared to budget and are explanations of variances reviewed by management?
  - d. Is a separate budget prepared by the manager of each department or division?
2. Does the bank's accounting system provide sufficiently detailed breakdowns of accounts to enable it to analyze fluctuations?
- \*3. Are the general books of the bank maintained by someone who does not have access to cash?
4. Are all general ledger entries processed through the proof department?
5. Are all entries to the general ledger supported by a general ledger ticket?
6. Do general ledger tickets, both debit and credit, bear complete approvals, descriptions and an indication of the offset?
- \*7. Are all general ledger entries approved by a responsible person other than the general ledger bookkeeper or person associated with its preparation?
8. Is the general ledger posted daily?
9. Is a daily statement of condition prepared?
- \*10. Are corrections to ledgers made by posting a correcting entry and not by erasing (manual system) or deleting (computerized system) the incorrect entry?
11. Are supporting worksheets or other records maintained on accrued expenses and taxes?
12. Are those supporting records periodically reconciled with the appropriate general ledger controls?

### PURCHASES

- \*13. If the bank has a separate purchasing department, is it independent of the accounting and receiving departments?
- \*14. Are purchases made only on the basis of requisitions signed by authorized individuals?
- \*15. Are all purchases routed through a purchasing department or personnel functioning in that capacity?
16. Are all purchases made by means of pre-numbered purchase orders sent to vendors?
17. Are all invoices received checked against purchase orders and receiving reports?
18. Are all invoices tested for clerical accuracy?
19. Are invoice amounts credited to their respective accounts and tested periodically for accuracy?

### DISBURSEMENTS

- \*20. Is the payment for all purchases, except minor items, made by official checks?
- \*21. Does the official signing the check review all supporting documents?
- \*22. Are supporting vouchers and invoices cancelled to prevent re-use?
- \*23. Are duties and responsibilities in the following areas segregated?
  - a. Authorization to issue expense checks?
  - b. Preparation of expense checks?
  - c. Signing of expense checks?
  - d. Sending of expense checks?
  - e. Use and storage of facsimile signatures?
  - f. General ledger posting?
  - g. Subsidiary ledger posting?

### PAYROLL

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



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

## CONCLUSION

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

### FACTORS INFLUENCING LIQUIDITY MANAGEMENT AND TYPES OF LIQUIDITY RISK

Liquidity is a financial institution's capacity to meet its cash and collateral obligations without incurring unacceptable losses. Adequate liquidity is dependent upon the institution's ability to efficiently meet both expected and unexpected cash flows and collateral needs without adversely affecting either daily operations or the financial condition of the institution. An institution's obligations and the funding sources used to meet them depend significantly on its business mix, balance-sheet structure, and the cash-flow profiles of its on- and off-balance-sheet obligations. In managing their cash flows, institutions confront various situations that can give rise to increased liquidity risk. These include funding mismatches, market constraints on the ability to convert assets into cash or in accessing sources of funds (i.e., market liquidity), and contingent liquidity events. Changes in economic conditions or exposure to credit, market, operation, legal, and reputation risks also can affect an institution's liquidity-risk profile and should be considered in the assessment of liquidity and asset/liability management.

Liquidity risk is the risk to an institution's financial condition or safety and soundness arising from its inability (whether real or perceived) to meet its contractual obligations. Because banking organizations employ a significant amount of leverage in their business activities—and need to meet contractual obligations in order to maintain the confidence of customers and fund providers—adequate liquidity is critical to an institution's ongoing operation, profitability, and safety and soundness.

To ensure it has adequate liquidity, an institution must balance the costs and benefits of liquidity: Too little liquidity can expose an institution to an array of significant negative repercussions arising from its inability to meet contractual obligations. Conversely, too much liquidity can entail substantial opportunity costs and have a negative impact on the firm's profitability.

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Note: The guidance complements existing guidance in the *Bank Holding Company Supervision Manual* (section 4010.2) and various SR-letters (see the "References" section).

Effective liquidity management entails the following three elements:

- assessing, on an ongoing basis, the current and expected future needs for funds, and ensuring that sufficient funds or access to funds exists to meet those needs at the appropriate time
- providing for an adequate cushion of liquidity with a stock of liquid assets to meet unanticipated cash-flow needs that may arise from a continuum of potential adverse circumstances that can range from high-probability/low-severity events that occur in daily operations to low-probability/high-severity events that occur less frequently but could significantly affect an institution's safety and soundness
- striking an appropriate balance between the benefits of providing for adequate liquidity to mitigate potential adverse events and the cost of that liquidity

The primary role of liquidity-risk management is to (1) prospectively assess the need for funds to meet obligations and (2) ensure the availability of cash or collateral to fulfill those needs at the appropriate time by coordinating the various sources of funds available to the institution under normal and stressed conditions. Funds needs arise from the myriad of banking activities and financial transactions that create contractual obligations to deliver funds, including business initiatives for asset growth, the provision of various financial products and transaction services, and expected and unexpected changes in assets and the liabilities used to fund assets. Liquidity managers have an array of alternative sources of funds to meet their liquidity needs. These sources generally fall within one of four broad categories:

- net operating cash flows
- the liquidation of assets
- the generation of liabilities
- an increase in capital funds

Funds obtained from operating cash flows arise from net interest payments on assets; net principal payments related to the amortization and maturity of assets; and the receipt of funds from various types of liabilities, transactions, and service fees. Institutions obtain liquidity from operating cash flows by managing the

timing and maturity of their asset and liability cash flows, including their ongoing borrowing and debt-issuance programs.

Funds can also be obtained by reducing or liquidating assets. Most institutions incorporate scheduled asset maturities and liquidations as part of their ongoing management of operating cash flows. They also use the potential liquidation of a portion of their assets (generally a portion of the investment portfolio) as a contingent source of funds to meet cash needs under adverse liquidity circumstances. Such contingent funds need to be unencumbered for the purposes of selling or lending the assets and are often termed *liquidity reserves* or *liquidity warehouses* and are a critical element of safe and sound liquidity management. Assessments of the value of unencumbered assets should represent the amount of cash that can be obtained from monetized assets under normal as well as stressed conditions.

Asset securitization is another method that some institutions use to fund assets. Securitization involves the transformation of on-balance-sheet loans (e.g., auto, credit card, commercial, student, home equity, and mortgage loans) into packaged groups of loans in various forms, which are subsequently sold to investors. Depending on the business model employed, securitization proceeds can be both a material source of ongoing funding and a significant tool for meeting future funding needs. Securitization markets may provide a good source of funding; however, institutions should be cautious in relying too heavily on this market as it has been known to shutdown under market stress situations.

Funds are also generated through deposit-taking activities, borrowings, and overall liability management. Borrowed funds may include secured lending and unsecured debt obligations across the maturity spectrum. In the short term, borrowed funds may include purchased fed funds and securities sold under agreements to repurchase (repos). Longer-term borrowed funds may include various types of deposit products, collateralized loans, and the issuance of corporate debt. Depending on their contractual characteristics and the behavior of fund providers, borrowed funds can vary in maturity and availability because of their sensitivity to general market trends in interest rates and various other market factors. Considerations specific to the borrowing institution also affect the maturity and availability of borrowed funds.

## External Factors and Exposure to Other Risks

The liquidity needs of a financial institution and the sources of liquidity available to meet those needs depend significantly on the institution's business mix and balance-sheet structure, as well as on the cash-flow profiles of its on- and off-balance-sheet obligations. While management largely determines these internal attributes, external factors and the institution's exposure to various types of financial and operating risks, including interest-rate, credit, operational, legal, and reputational risks, also influence its liquidity profile. As a result, an institution should assess and manage liquidity needs and sources by considering the potential consequences of changes in external factors *along with* the institution-specific determinants of its liquidity profile.

### *Changes in Interest Rates*

The level of prevailing market interest rates, the term structure of interest rates, and changes in both the level and term structure of rates can significantly affect the cash-flow characteristics and costs of, and an institution's demand for, assets, liabilities, and off-balance-sheet (OBS) positions. In turn, these factors significantly affect an institution's funding structure or liquidity needs, as well as the relative attractiveness or price of alternative sources of liquidity available to it. Changes in the level of market interest rates can also result in the acceleration or deceleration of loan prepayments and deposit flows. The availability of different types of funds may also be affected, as a result of options embedded in the contractual structure of assets, liabilities, and financial transactions.

### *Economic Conditions*

Cyclical and seasonal economic conditions can also have an impact on the volume of an institution's assets, liabilities, and OBS positions—and, accordingly, its cash-flow and liquidity profile. For example, during recessions, business demand for credit may decline, which affects the growth of an organization and its liquidity needs. At the same time, subpar economic growth and its impact on employ-

ment, bankruptcies, and business failures often create direct and indirect incentives for retail customers to reduce their deposits; a recession may also lead to higher loan delinquencies for financial institutions. All of these conditions have negative implications for an institution's cash flow and overall liquidity. On the other hand, periods of economic growth may spur asset or deposit growth, thus introducing different liquidity challenges.

### *Credit-Risk Exposures of an Institution*

An institution's exposure to credit risk can have a material impact on its liquidity. Nonperforming loans directly reduce otherwise expected cash inflows. The reduced credit quality of problem assets impairs their marketability and potential use as a source of liquidity (either by selling the assets or using them as collateral). Moreover, problem assets have a negative impact on overall cash flows by increasing the costs of loan-collection and -workout efforts.

In addition, the price that a bank pays for funds, especially wholesale and brokered borrowed funds and deposits, will reflect the institution's perceived level of risk exposure in the marketplace. Fund suppliers use a variety of credit-quality indicators to judge credit risk and determine the returns they require for the risk to be undertaken. Such indicators include an institution's loan-growth rates; the relative size of its loan portfolio; and the levels of delinquent loans, nonperforming loans, and loan losses. For institutions that have issued public debt, the credit ratings of nationally recognized statistical rating organizations (NRSOs) are particularly critical.

### *Other Risk Exposures of an Institution*

Importantly, exposures to operational, legal, reputational, and other risks can lead to adverse liquidity conditions. Operating risks can materially disrupt the dispersal and receipt of obligated cash flows and give rise to significant liquidity needs. Exposure to legal and reputational risks can lead fund providers to question an institution's overall credit risk, safety and soundness, and ability to meet its obligations in the future. A bank's reputation for operating in a safe and sound manner, particularly its ability to meet its contractual obligations, is an impor-

tant determinant in its costs of funds and overall liquidity-risk profile.

Given the critical importance of liquidity to financial institutions and the potential impact that other risk exposures and external factors have on liquidity, effective liquidity managers ensure that liquidity management is fully integrated into the institution's overall enterprise-wide risk-management activities. Liquidity management is therefore an important part of an institution's strategic and tactical planning.

### Types of Liquidity Risk

Banking organizations encounter the following three broad types of liquidity risk:

- mismatch risk
- market liquidity risk
- contingent liquidity risk

Mismatch risk is the risk that an institution will not have sufficient cash to meet obligations in the normal course of business, as a result of ineffective matches between cash inflows and outflows. The management and control of funding mismatches depend greatly on the daily projections of operational cash flow, including those cash flows that may arise from seasonal business fluctuations, unanticipated new business, and other everyday situations. To accurately project operational cash flows, an institution needs to estimate its expected cash-flow needs and ensure it has adequate liquidity to meet small variations to those expectations. Occurrences of funding mismatches may be frequent. If adequately managed, these mismatches may have little to no impact on the financial health of the firm.

Market liquidity risk is the risk that an institution will encounter market constraints in its efforts to convert assets into cash or to access financial market sources of funds.

The planned conversion of assets into cash is an important element in an institution's ongoing management of funding cash-flow mismatches. In addition, converting assets into cash is often a key strategic tool for addressing contingent liquidity events. As a result, market constraints on achieving planned, strategic, or contingent conversions of assets into cash can exacerbate the severity of potential funding mismatches and contingent liquidity problems.

Contingent liquidity risk is the risk that arises when unexpected events cause an institution to have insufficient funds to meet its obligations. Unexpected events may be firm-specific or arise from external factors. External factors may be geographic, such as local economic factors that affect the premiums required on deposits with certain local, state, or commercial areas, or they may be market-oriented, such as increases in the price volatility of certain types of securities in response to financial market developments. External factors may also be systemic, such as a payment-system disruption or major changes in economic or financial market conditions.

The nature and severity of contingent liquidity events vary substantially. At one extreme, contingent liquidity risk may arise from the need to fund unexpected asset growth as a result of commitment requests or the unexpected runoff of liabilities that occurs in the normal course of business. At the other extreme, institution-specific issues, such as the lowering of a public debt rating or general financial market stress, may have a significant impact on an institution's liquidity and safety and soundness. As a result, managing contingent liquidity risk requires an ongoing assessment of potential future events and circumstances in order to ensure that obligations are met and adequate sources of standby liquidity and/or liquidity reserves are readily available and easily converted to cash.

Diversification plays an important role in managing liquidity and its various component risks. Concentrations in particular types of assets, liabilities, OBS positions, or business activities that give rise to unique types of funding needs or create an undue reliance on specific types of funding sources can unduly expose an institution to the risks of funding mismatches, contingent events, and market liquidity constraints. Therefore, diversification of both the sources and uses of liquidity is a critical component of sound liquidity-risk management.

## SOUND LIQUIDITY-RISK MANAGEMENT PRACTICES

Like the management of any type of risk, sound liquidity-risk management involves effective oversight of a comprehensive process that adequately identifies, measures, monitors, and controls risk exposure. This process includes oversight of exposures to funding mismatches, market liquidity constraints, and contingent

liquidity events. Both international and U.S. banking supervisors have issued supervisory guidance on safe and sound practices for managing the liquidity risk of banking organizations. Guidance on liquidity risk management was published by the Basel Committee on Banking Supervision, Bank for International Settlements, "Principles for Sound Liquidity Risk Management and Supervision," in September 2008.<sup>1</sup> The U.S. regulatory agencies implemented these principles, jointly agreeing to incorporate those principles into their existing guidance. The revised guidance, "Interagency Policy Statement on Funding and Liquidity Risk Management" was issued on March 10, 2010 (see SR-10-6 and its attachment).

In summary, the critical elements of a sound liquidity-risk management process are—

- Effective corporate governance consisting of oversight by the board of directors and active involvement by management in an institution's control of liquidity risk.
- Appropriate strategies, policies, procedures, and limits used to manage and mitigate liquidity risk.
- Comprehensive liquidity-risk measurement and monitoring systems (including assessments of the current and prospective cash flows or sources and uses of funds) that are commensurate with the complexity and business activities of the institution.
- Active management of intraday liquidity and collateral.
- An appropriately diverse mix of existing and potential future funding sources.
- Adequate levels of highly liquid marketable securities free of legal, regulatory, or operational impediments that can be used to meet liquidity needs in stressful situations.
- Comprehensive contingency funding plans (CFPs) that sufficiently address potential adverse liquidity events and emergency cash flow requirements.
- Internal controls and internal audit processes sufficient to determine the adequacy of the institution's liquidity-risk-management process.

Each of these elements should be customized to account for the sophistication, complexity, and

1. Basel Committee on Banking Supervision, "Principles for Sound Liquidity Risk Management and Supervision," September 2008. See [www.bis.org/publ/bcb144.htm](http://www.bis.org/publ/bcb144.htm).

business activities of an institution. The following sections discuss supervisory expectations for each of these critical elements.

## Corporate Governance and Oversight

Effective liquidity-risk management requires the coordinated efforts of both an informed board of directors and capable senior management. The board should establish and communicate the institution's liquidity-risk tolerance in such a manner that all levels of management clearly understand the institution's approach to managing the trade-offs between management of liquidity risk and short-term profits. The board should ensure that the organizational structures and staffing levels are appropriate, given the institution's activities and the risks they present.

### *Involvement of the Board of Directors*

The board of directors is ultimately responsible for the liquidity risk assumed by the institution. The board should understand and guide the strategic direction of liquidity-risk management. Specifically, the board of directors or a delegated committee of board members should oversee the establishment and approval of liquidity management strategies, policies and procedures, and review them at least annually. In addition, the board should ensure that it

- understands the nature of the institution's liquidity risks and periodically reviews information necessary to maintain this understanding;
- understands and approves those elements of liquidity-risk management policies that articulate the institution's general strategy for managing liquidity risk, and establishes acceptable risk tolerances;
- establishes executive-level lines of authority and responsibility for managing the institution's liquidity risk;
- enforces management's duties to identify, measure, monitor, and control liquidity risk.
- understands and periodically reviews the institution's CFP for handling potential adverse liquidity events; and
- understands the liquidity-risk profile of important subsidiaries and affiliates and their influence on the overall liquidity of the financial institution, as appropriate.

## *Role of Senior Management*

Senior management should ensure that liquidity-risk management strategies, policies, and procedures are adequate for the sophistication and complexity of the institution. Management should ensure that these policies and procedures are appropriately executed on both a long-term and day-to-day basis, in accordance with board delegations. Management should oversee the development and implementation of—

- an appropriate risk-measurement system and standards for measuring the institution's liquidity risk;
- a comprehensive liquidity-risk reporting and monitoring process;
- establishment and monitoring of liquid asset buffers of unencumbered marketable securities;
- effective internal controls and review processes for the management of liquidity risk; and
- monitoring of liquidity risks for each entity across the institution on an on-going basis and;
- an appropriate CFP, including (1) adequate assessments of the institution's contingent liquidity risks under adverse circumstances and (2) fully developed strategies and plans for managing such events.

Senior management should periodically review the organization's liquidity-risk management strategies, policies, and procedures, as well as its CFP, to ensure that they remain appropriate and sound. Management should also coordinate the institution's liquidity-risk management with its efforts for disaster, contingency, and strategic planning, as well as with its business and risk-management objectives, strategies, and tactics. Senior management is also responsible for regularly reporting to the board of directors on the liquidity-risk profile of the institution.

## Strategies, Policies, Procedures, and Risk Tolerances

Institutions should have documented strategies for managing liquidity and have formal written policies and procedures for limiting and controlling risk exposures. Strategies, policies, and procedures should translate the board's goals,

objectives, and risk tolerances into operating standards that are well understood by institutional personnel and that are consistent with the board's intended risk tolerances. Policies should also ensure that responsibility for managing liquidity is assigned throughout the corporate structure of the institution, including separate legal entities and relevant operating subsidiaries and affiliates, where appropriate. Strategies set out the institution's general approach for managing liquidity, articulate its liquidity-risk tolerances, and address the extent to which key elements of funds management are centralized or delegated throughout the institution. Strategies also communicate how much emphasis the institution places on using asset liquidity, liabilities, and operating cash flows to meet its day-to-day and contingent funding needs. Quantitative and qualitative targets, such as the following, may also be included in policies:

- guidelines or limits on the composition of assets and liabilities
- the relative reliance on certain funding sources, both on an ongoing basis and under contingent liquidity scenarios
- the marketability of assets to be used as contingent sources of liquidity

An institution's strategies and policies should identify the primary objectives and methods for (1) managing daily operating cash flows, (2) providing for seasonal and cyclical cash-flow fluctuations, and (3) addressing various adverse liquidity scenarios. The latter includes formulating plans and courses of actions for dealing with potential temporary, intermediate-term, and long-term liquidity disruptions. Policies and procedures should formally document—

- lines of authority and responsibility for managing liquidity risk,
- liquidity-risk limits and guidelines,
- the institution's measurement and reporting systems, and
- elements of the institution's comprehensive CFP.

Incorporating these elements of liquidity-risk management into policies and procedures helps internal control and internal audit fulfill their oversight role in the liquidity-risk management process. Policies, procedures, and limits should address liquidity separately for individual currencies, where appropriate and material. All

liquidity-risk policies, procedures, and limits should be reviewed periodically and revised as needed.

### *Delineating Clear Lines of Authority and Responsibility*

Through formal written policies or clear operating procedures, management should delineate managerial responsibilities and oversight, including lines of authority and responsibility for the following:

- developing liquidity-risk management policies, procedures, and limits
- developing and implementing strategies and tactics for managing liquidity risk
- conducting day-to-day management of the institution's liquidity
- establishing and maintaining liquidity-risk measurement and monitoring systems
- authorizing exceptions to policies and limits
- identifying the potential liquidity risk associated with the introduction of new products and activities

Institutions should clearly identify the individuals or committees responsible for liquidity-risk decisions. Less complex institutions often assign such responsibilities to the CFO or an equivalent senior management official. Other institutions assign responsibility for liquidity-risk management to a committee of senior managers, sometimes called a finance committee or an asset/liability committee (ALCO). Policies should clearly identify individual or committee duties and responsibilities, the extent of the decision-making authority, and the form and frequency of periodic reports to senior management and the board of directors. In general, an ALCO (or a similar senior-level committee) is responsible for ensuring that (1) measurement systems adequately identify and quantify the institution's liquidity-risk exposure and (2) reporting systems communicate accurate and relevant information about the level and sources of that exposure.

When an institution uses an ALCO or other senior management committee, the committee should actively monitor the liquidity profile of the institution and should have sufficiently broad representation from the major institutional functions that influence liquidity risk (e.g., the lending, investment, deposit, or funding functions).

Committee members should include senior managers who have authority over the units responsible for executing transactions and other activities that can affect liquidity. In addition, the committee should ensure that (1) the risk-measurement system adequately identifies and quantifies risk exposure and (2) the reporting process communicates accurate, timely, and relevant information about the level and sources of risk exposure.

In general, committees overseeing liquidity-risk management delegate the day-to-day responsibilities to the institution's treasury department or, at less complex institutions, to the CFO, treasurer, or other appropriate staff. The personnel charged with measuring and monitoring the day-to-day management of liquidity risk should have a well-founded understanding of all aspects of the institution's liquidity-risk profile. While the day-to-day management of liquidity may be delegated, the oversight committee should not be precluded from aggressively monitoring liquidity management.

In more-complex institutions that have separate legal entities and operating subsidiaries or affiliates, effective liquidity-risk management requires senior managers and other key personnel to have an understanding of the funding position and liquidity of any member of the corporate group that might provide or absorb liquid resources from another member. Centralized liquidity-risk assessment and management can provide significant operating efficiencies and comprehensive views of the liquidity-risk profile of the integrated corporate entity as well as members of the corporate group—including depository institutions. This integrated view is particularly important for understanding the impact other members of the group may have on insured depository entities. However, legal and regulatory restrictions on the flow of funds among members of a corporate group, in addition to differences in the liquidity characteristics and dynamics of managing the liquidity of different types of entities within a group, may call for decentralizing various elements of liquidity-risk management. Such delegation and associated strategies, policies, and procedures should be clearly articulated and understood throughout the organization. Policies, procedures, and limits should also address liquidity separately for individual currencies, legal entities, and business lines, when appropriate and material, as well as allow for legal, regulatory, and operational limits for the transferability of liquidity.

### *Diversified Funding*

An institution should establish a funding strategy that provides effective diversification in the sources and tenor of funding. It should maintain an ongoing presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. An institution should regularly gauge its capacity to raise funds quickly from each source. It should identify the main factors that affect its ability to raise funds and monitor those factors closely to ensure that estimates of fund raising capacity remain valid.

An institution should diversify available funding sources in the short-, medium- and long-term. Diversification targets should be part of the medium- to long-term funding plans and should be aligned with the budgeting and business planning process. Funding plans should take into account correlations between sources of funds and market conditions. Funding should also be diversified across a full range of retail as well as secured and unsecured wholesale sources of funds, consistent with the institution's sophistication and complexity. Management should also consider the funding implications of any government programs or guarantees it utilizes. As with wholesale funding, the potential unavailability of government programs over the intermediate- and long-term should be fully considered in the development of liquidity risk management strategies, tactics, and risk tolerances. Funding diversification should be implemented using limits addressing counterparties, secured versus unsecured market funding, instrument type, securitization vehicle, and geographic market. In general, funding concentrations should be avoided. Undue over reliance on any one source of funding is considered an unsafe and unsound practice.

An essential component of ensuring funding diversity is maintaining market access. Market access is critical for effective liquidity risk management, as it affects both the ability to raise new funds and to liquidate assets. Senior management should ensure that market access is being actively managed, monitored, and tested by the appropriate staff. Such efforts should be consistent with the institution's liquidity-risk profile and sources of funding. For example, access to the capital markets is an important consideration for most large complex institutions, whereas the availability of correspondent lines of credit and other sources of whole funds



are critical for smaller, less complex institutions.

An institution needs to identify alternative sources of funding that strengthen its capacity to withstand a variety of severe institution-specific and market-wide liquidity shocks. Depending upon the nature, severity, and duration of the liquidity shock, potential sources of funding include, but are not limited to, the following:

- Deposit growth.
- Lengthening maturities of liabilities.
- Issuance of debt instruments.
- Sale of subsidiaries or lines of business.
- Asset securitization.
- Sale (either outright or through repurchase agreements) or pledging of liquid assets.
- Drawing-down committed facilities.
- Borrowing.

### *Liquidity-Risk Limits and Guidelines*

Liquidity-risk tolerances or limits should be appropriate for the complexity and liquidity-risk profile of an institution. They should employ both quantitative targets and qualitative guidelines and should be consistent with the institution's overall approach and strategy for measuring and managing liquidity. Policies should clearly articulate a liquidity-risk tolerance that is appropriate for the business strategy of the institution, considering its complexity, business mix, liquidity-risk profile, and its role in the financial system. Policies should also contain provisions for documenting and periodically reviewing assumptions used in liquidity projections. Policy guidelines should employ both quantitative targets and qualitative guidelines. These measurements, limits, and guidelines may be specified in terms of the following measures and conditions, as applicable:

- *Discrete or cumulative cash-flow mismatches or gaps (sources and uses of funds) over specified future short- and long-term time horizons under both expected and adverse business conditions.* Often, these are expressed as cash-flow coverage ratios or as specific aggregate amounts.
- *Target amounts of unpledged liquid-asset reserves sufficient to meet liquidity needs under normal and reasonably anticipated adverse business conditions.* These targets are often expressed as aggregate amounts or as ratios calculated in relation to, for example,

total assets, short-term assets, various types of liabilities, or projected-scenario liquidity needs.

- *Volatile liability dependence and liquid-asset coverage of volatile liabilities under both normal and stress conditions.* These guidelines, for example, may include amounts of potentially volatile wholesale funding to total liabilities, volatile retail (e.g., high-cost or out-of-market) deposits to total deposits, potentially volatile deposit-dependency measures, or short-term borrowings as a percent of total funding.
- *Asset concentrations that could increase liquidity risk through a limited ability to convert to cash* (e.g., complex financial instruments, bank-owned (corporate-owned) life insurance, and less-marketable loan portfolios).
- *Funding concentrations that address diversification issues, such as a large liability and dependency on borrowed funds, concentrations of single funds providers, funds providers by market segments, and types of volatile deposit or volatile wholesale funding dependency.* For small community banks, funding concentrations may be difficult to avoid. However, banks that rely on just a few primary sources should have appropriate systems in place to manage the concentrations of funding liquidity, including limit structures and reporting mechanisms.
- *Funding concentrations that address the term, re-pricing, and market characteristics of funding sources.* This may include diversification targets for short-, medium-, and long-term funding, instrument type and securitization vehicles, and guidance on concentrations for currencies and geographical markets.
- *Contingent liabilities, such as unfunded loan commitments and lines of credit supporting asset sales or securitizations, and collateral requirements for derivatives transactions and various types of secured lending.*
- *The minimum and maximum average maturity of different categories of assets and liabilities.*

Institutions may use other risk indicators to specify their risk tolerances. Some institutions may use ratios such as loans to deposits, loans to equity capital, purchased funds to total assets, or other common measures. However, when developing and using such measures, institutions should be fully aware that some measures may not appropriately assess the timing and scenario-specific characteristics of the

institution's liquidity-risk profile. *Liquidity-risk measures that are constructed using static balance-sheet amounts may hide significant liquidity risk that can occur in the future under both normal and adverse business conditions. As a result, institutions should not rely solely on these static measures to monitor and manage liquidity.*

### *Policies on Measuring and Managing Reporting Systems*

Policies and procedures should also identify the methods used to measure liquidity risk, as well as the form and frequency of reports to various levels of management and the board of directors. Policies should identify the nature and form of cash-flow projections and other liquidity measures to be used. Policies should provide for the categorization, measurement, and monitoring of both stable and potentially volatile sources of funds. Policies should also provide guidance on the types of business-condition scenarios used to construct cash-flow projections and should contain provisions for documenting and periodically reviewing the assumptions used in liquidity projections.

Moreover, policies should explicitly provide for more-frequent reporting under adverse business or liquidity conditions. Under normal business conditions, senior managers should receive liquidity-risk reports at least monthly, while the board of directors should receive liquidity-risk reports at least quarterly. If the risk exposure is more complex, the reports should be more frequent. These reports should tell senior management and the board how much liquidity risk the bank is assuming, whether management is complying with risk limits, and whether management's strategies are consistent with the board's expressed risk tolerance.

### *Policies on Contingency Funding Plans*

Policies should also provide for senior management to develop and maintain a written, comprehensive, and up-to-date liquidity CFP. Policies should also ensure that, as part of ongoing liquidity-risk management, senior management is alerted to early-warning indicators or triggers of potential liquidity problems.

### *Compliance with Laws and Regulations*

Institutions should ensure that their policies and procedures take into account compliance with appropriate laws and regulations that can have an impact on an institution's liquidity-risk management and liquidity-risk profile. These laws and regulations include the Federal Deposit Insurance Corporation Improvement Act (FDICIA) and its constraints on an institution's use of brokered deposits, as well as pertinent sections of Federal Reserve regulations A, D, F, and W. (See appendix 2, for a summary of some of the pertinent legal and regulatory issues that should be factored into the management of liquidity risk.)

### *Liquidity-Risk Measurement Systems*

The analysis and measurement of liquidity risk should be tailored to the complexity and risk profile of an institution, incorporating the cash flows and liquidity implications of all the institution's material assets, liabilities, off-balance-sheet positions, and major business activities. Liquidity-risk analysis should consider what effect options embedded in the institution's sources and uses of funds may have on its cash flows and liquidity-risk measures. The analysis of liquidity risk should also be forward-looking and strive to identify potential future funding mismatches as well as current imbalances. Liquidity-risk measures should advance management's understanding of the institution's exposure to mismatch, market, and contingent liquidity risks. Measures should also assess the institution's liquidity sources and needs in relation to the specific business environments it operates in and the time frames involved in securing and using funds.

Adequate liquidity-risk measurement requires the ongoing review of an institution's sources and uses of funds and generally includes analysis of the following:

- trends in balance-sheet structure and funding vehicles
- pro forma cash-flow statements and funding mismatch gaps over varying time horizons
- trends and expectations in the volume and pricing trends for assets, liabilities, and off-balance-sheet items that can have a significant impact on the institution's liquidity

- trends in the relative costs of funds required by existing and alternative funds providers
- the diversification of funding sources and trends in funding concentrations
- the adequacy of asset liquidity reserves, trends in these reserves, and the market dynamics that could influence their market liquidity
- the sensitivity of funds providers to both financial market and institution-specific trends and events
- the institution's exposure to both broad-based market and institution-specific contingent liquidity events

The formality and sophistication of liquidity-risk measurement, and the policies and procedures used to govern the measurement process, depend on the sophistication of the institution, the nature and complexity of its funding structures and activities, and its overall liquidity-risk profile.

(See appendix 1, for background information on the types of liquidity analysis and measures of liquidity risk used by effective liquidity-risk managers. The appendix also discusses the considerations for evaluating the liquidity-risk characteristics of various assets, liabilities, OBS positions, and other activities, such as asset securitization, that can influence an institution's liquidity.)

### *Pro Forma Cash-Flow Analysis*

Regardless of the size and complexity of an institution, pro forma cash-flow statements are a critical tool for adequately managing liquidity risk. In the normal course of measuring and managing liquidity risk and analyzing their institution's sources and uses of funds, effective liquidity managers project cash flows under expected and alternative liquidity scenarios. Such cash-flow-projection statements range from simple spreadsheets to very detailed reports, depending on the complexity and sophistication of the institution and its liquidity-risk profile.

A sound practice is to project, on an ongoing basis, an institution's cash flows under normal business-as-usual conditions, incorporating appropriate seasonal and business-growth considerations over varying time horizons. This cash-flow projection should be regularly reviewed under both short-term and intermediate- to long-term institution-specific contingent scenarios. Institutions that have more-complex liquidity-

risk profiles should also assess their exposure to broad systemic and adverse financial market events, as appropriate to their business mix and overall liquidity-risk profile (e.g., securitization, derivatives, trading, processing, international, and other activities).

The construction of pro forma cash-flow statements under alternative scenarios and the ongoing monitoring of an institution's liquidity-risk profile depend importantly on liquidity management's review of trends in the institution's balance-sheet structure and its funding sources. This review should consider past experience and include expectations for the volume and pricing of assets, liabilities, and off-balance-sheet items that may significantly affect the institution's liquidity.

Effective liquidity-risk monitoring systems should assess (1) trends in the relative cost of funds, as required by the institution's existing and alternative funds providers; (2) the diversification or concentration of funding sources; (3) the adequacy of the institution's asset liquidity reserves; and (4) the sensitivity of funds providers to both financial market and institution-specific trends and events. *Detailed examples and further discussion of cash-flows are included in appendix 1, section I, "Basic Cash-Flow Projections."*

### *Assumptions*

Given the critical importance of assumptions in constructing liquidity-risk measures and projections of future cash flows, institutions should ensure that all their assumptions are reasonable and appropriate. Institutions should document and periodically review and approve key assumptions. Assumptions used in assessing the liquidity risk of complex instruments and assets; liabilities; and OBS positions that have uncertain cash flows, market value, or maturities should be subject to rigorous documentation and review.

Assumptions about the stability or volatility of retail deposits, brokered deposits, wholesale or secondary-market borrowings, and other funding sources with uncertain cash flows are particularly important—especially when such assumptions are used to evaluate alternative sources of funds under adverse contingent liquidity scenarios (such as a deterioration in asset quality or capital). When assumptions about the performance of deposits and other sources of

funds are used in the computation of liquidity measures, these assumptions should be based on reasoned analysis considering such factors as the following:

- the historical behavior of deposit customers and funds providers
- how current or future business conditions may change the historical responses and behaviors of customers and other funds providers
- the general conditions and characteristics of the institution's market for various types of funds, including the degree of competition
- the anticipated pricing behavior of funds providers (for instance, wholesale or retail) under the scenario investigated
- haircuts (that is, the reduction from the stated value of an asset) applied to assets earmarked as contingent liquidity reserves

*Further discussion of liquidity characteristics of assets, liabilities, and off-balance-sheet items is included in appendix I, section III, "Liquidity Characteristics of Assets, Liabilities, Off-Balance-Sheet Positions, and Various Types of Banking Activities."* Institutions that have complex liquidity profiles should perform sensitivity tests to determine what effect any changes to its material assumptions will have on its liquidity.

Institutions should ensure that assets are properly valued according to relevant financial reporting and supervisory standards. An institution should fully factor into its risk management the consideration that valuations may deteriorate under market stress and take this into account in assessing the feasibility and impact of asset sales on its liquidity position during stress events.

Institutions should ensure that their vulnerabilities to changing liquidity needs and liquidity capacities are appropriately assessed within meaningful time horizons, including intraday, day-to-day, short-term weekly and monthly horizons, medium-term horizons of up to one year, and longer-term liquidity needs over one year. These assessments should include vulnerabilities to events, activities, and strategies that can significantly strain the capability to generate internal cash.

### *Stress Testing*

Once normal operating cash-flow statements are established then those tools can be used to generate stress tests. Stress assumptions are

simply layered on top of the normal operating cash-flow projections. The quantitative results provided by the stress test also serve as a key component within the CFP.

Institutions should conduct stress tests on a regular basis for a variety of institution-specific and market-wide events across multiple time horizons. The magnitude and frequency of stress testing should be commensurate with the complexity of the financial institution and the level of its risk exposures. Stress test outcomes should be used to identify and quantify sources of potential liquidity strain and to analyze possible impacts on the institution's cash flows, liquidity position, profitability, and solvency.

Stress tests should also be used to ensure that current exposures are consistent with the financial institution's established liquidity-risk tolerance. The stress test serves as a key component of the CFP and the quantification of the risk to which the institution may be exposed. Management's active involvement and support is critical to the effectiveness of the stress-testing process. Management should discuss the results of stress tests and take remedial or mitigating actions to limit the institution's exposures, build up a liquidity cushion, and adjust its liquidity profile to fit its risk tolerance. The results of stress tests therefore play a key role in determining the amount of buffer assets the institution should maintain.

### *Cushion of Liquid Assets*

Liquid assets are an important source of both primary (operating liquidity) and secondary (contingent liquidity) funding at many institutions. Indeed, a critical component of an institution's ability to effectively respond to potential liquidity stress is the availability of a cushion of highly liquid assets without legal, regulatory, or operational impediments (i.e., unencumbered) that can be sold or pledged to obtain funds in a range of stress scenarios. These assets should be held as insurance against a range of liquidity stress scenarios, including those that involve the loss or impairment of typically available unsecured and/or secured funding sources. The size of the cushion of such high-quality liquid assets should be supported by estimates of liquidity needs performed under an institution's stress testing as well as aligned with the risk tolerance and risk profile of the institution. Management estimates of liquidity needs during periods of

stress should incorporate both contractual and non-contractual cash flows, including the possibility of funds being withdrawn. Such estimates should also assume the inability to obtain unsecured funding as well as the loss or impairment of access to funds secured by assets other than the safest, most liquid assets.

Management should ensure that unencumbered, highly liquid assets are readily available and are not pledged to payment systems or clearing houses. The quality of unencumbered liquid assets is important as it will ensure accessibility during the time of most need. For example, an institution could utilize its holdings of high-quality U.S. Treasury securities, or similar instruments, and enter into repurchase agreements in response to the most severe stress scenarios.

## Liquidity-Risk Monitoring and Reporting Systems

Methods used to monitor and measure liquidity risk should be sufficiently robust and flexible to allow for the timely computation of the metrics an institution uses in its ongoing liquidity-risk management. Risk monitoring and reporting systems should regularly provide information on day-to-day liquidity management and risk control; this information should also be readily available during contingent liquidity events.

In keeping with the other elements of sound liquidity-risk management, the complexity and sophistication of management reporting and management information systems (MIS) should be consistent with the liquidity profile of the institution. For example, complex institutions that are highly dependent on wholesale funds may need daily reports on the use of various funding sources, maturities of various instruments, and rollover rates. Less complex institutions may require only simple maturity-gap or cash-flow reports that depict rollovers and mismatch risks; these reports may also include pertinent liquidity ratios. Liquidity-risk reports can be customized to provide management with aggregate information that includes sufficient supporting detail to enable them to assess the sensitivity of the institution to changes in market conditions, its own financial performance, and other important risk factors. Reportable items may include, but are not limited to—

- cash-flow gap-projection reports and forward-looking summary measures that assess both business-as-usual and contingent liquidity scenarios;
  - asset and funding concentrations that highlight the institution's dependence on funds that may be highly sensitive to institution-specific contingent liquidity or market liquidity risk (including information on the types and amounts of negotiable certificates of deposit (CDs) and other bank obligations, as well as information on major liquidity funds providers);
  - critical assumptions used in cash-flow projections and other measures;
  - the status of key early-warning signals or risk indicators;
  - funding availability;
  - reports on the impact of new products and activities;
  - reports documenting compliance with established policies and procedures; and
  - where appropriate, both consolidated and unconsolidated reports for institutions that have multiple offices, international branches, affiliates, or subsidiaries.
- Institutions should also report on the use of and availability of government support, such as lending and guarantee programs, and implications on liquidity positions, particularly since these programs are generally temporary or reserved as a source for contingent funding.

The types of reports or information and their timing should be tailored to the institution's funding strategies and will vary according to the complexity of the institution's operations and risk profile. For example, institutions relying on investment securities for their primary source of contingent liquidity should employ reports on the quality, pledging status, and maturity distribution of those assets. Similarly, institutions conducting securitization activities, or placing significant emphasis on the sale of loans to meet contingent liquidity needs, should customize their liquidity reports to target these activities.

### *Collateral-Position Management*

An institution should have the ability to calculate all of its collateral positions in a timely manner, including assets currently pledged relative to the amount of security required and

unencumbered assets available to be pledged. An institution's level of available collateral should be monitored by legal entity, by jurisdiction, and by currency exposure. Systems should be capable of monitoring shifts between intraday and overnight or term-collateral usage. An institution should be aware of the operational and timing requirements associated with accessing the collateral given its physical location (i.e., the custodian institution or securities settlement system with which the collateral is held). Institutions should also fully understand the potential demand on required and available collateral arising from various types of contractual contingencies during periods of both market-wide and institution-specific stress.

### *Liquidity Across Legal Entities, and Business Lines*

An institution should actively monitor and control liquidity-risk exposures and funding needs within and across legal entities and business lines, taking into account legal, regulatory, and operational limitations to the transferability of liquidity. Separately regulated entities will need to maintain liquidity commensurate with their own risk profiles on a stand-alone basis.

Regardless of its organizational structure, it is important that an institution actively monitor and control liquidity risks at the level of individual legal entities, and the group as a whole, incorporating processes that aggregate data across multiple systems in order to develop a group-wide view of liquidity-risk exposures and identify constraints on the transfer of liquidity within the group.

Assumptions regarding the transferability of funds and collateral should be described in liquidity-risk management plans.

### *Intraday Liquidity Position Management*

Intraday liquidity monitoring is an important component of the liquidity-risk management process for institutions engaged in significant payment, settlement, and clearing activities. An institution's failure to manage intraday liquidity effectively, under normal and stressed conditions, could leave it unable to meet payment and settlement obligations in a timely manner, adversely affecting its own liquidity position and that of its counterparties. Among large,

complex organizations, the interdependencies that exist among payment systems and the inability to meet certain critical payments has the potential to lead to systemic disruptions that can prevent the smooth functioning of all payment systems and money markets. Therefore, institutions with material payment, settlement and clearing activities should actively manage their intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions. Senior management should develop and adopt an intraday liquidity strategy that allows the institution to

- monitor and measure expected daily gross liquidity inflows and outflows.
- manage and mobilize collateral when necessary to obtain intraday credit.
- identify and prioritize time-specific and other critical obligations in order to meet them when expected.
- settle other less critical obligations as soon as possible.
- control credit to customers when necessary.

### Contingency Funding Plans

A CFP is a compilation of policies, procedures, and action plans for responding to contingent liquidity events. It is a sound practice for all institutions, regardless of size and complexity, to engage in comprehensive contingent liquidity planning. The objectives of the CFP are to provide a plan for responding to a liquidity crisis, identify a menu of contingent liquidity sources that the institution can use under adverse liquidity circumstances, and describe steps that should be taken to ensure that the institution's sources of liquidity are sufficient to fund scheduled operating requirements and meet the institution's commitments with minimal costs and disruption. CFPs should be commensurate with an institution's complexity, risk profile, and scope of operations.

Contingent liquidity events are unexpected situations or business conditions that may increase the risk that an institution will not have sufficient funds to meet liquidity needs. These events can negatively affect any institution, regardless of its size and complexity, by

- interfering with or preventing the funding of asset growth,

- disrupting the institution's ability to renew or replace maturing funds.

Contingent liquidity events may be institution-specific or arise from external factors. Institution-specific risks are determined by the risk profile and business activities of the institution. They generally are a result of unique credit, market, operational, and strategic risks taken by the institution. A potential result of this type of event would be customers unexpectedly exercising options to withdraw deposits or exercise off-balance-sheet (OBS) commitments.

In contrast, external contingent events may be systemic financial-market occurrences, such as

- increases or decreases in the price volatility of certain types of securities in response to market events;
- major changes in economic conditions, market perception, or dislocations in financial markets;
- disturbances in payment and settlement systems due to operational or local disasters.

Contingent liquidity events range from high-probability/low-impact events that occur during the normal course of business to low-probability/high-impact events that may have an adverse impact on an institution's safety and soundness. Institutions should incorporate planning for high-probability/low-impact liquidity risks into their daily management of the sources and uses of their funds. This objective is best accomplished by assessing possible variations in expected cash-flow projections and provisioning for adequate liquidity reserves in the normal course of business.

Liquidity risks driven by lower-probability, higher-impact events should be addressed in the CFP, which should—

- identify reasonably plausible stress events;
- evaluate those stress events under different levels of severity;
- make a quantitative assessment of funding needs under the stress events;
- identify potential funding sources in response to a stress event; and
- provide for commensurate management processes, reporting, and external communication throughout a stress event.

The CFP should address both the severity and duration of contingent liquidity events. The

liquidity pressures resulting from low-probability, high-impact events may be immediate and short term, or they may present sustained situations that have long-term liquidity implications. The potential length of an event should factor into decisions about sources of contingent liquidity.

### *Identifying Liquidity Stress Events*

Stress events are those events that may have a significant impact on an institution's liquidity, given its specific balance-sheet structure, business lines, organizational structure, and other characteristics. Possible stress events include changes in credit ratings, a deterioration in asset quality, a prompt-corrective-action (PCA) downgrade, and CAMELS ratings downgrade widening of credit default spreads, operating losses, negative press coverage, or other events that call into question an institution's ability to meet its obligations.

An institution should customize its CFP. Separate CFPs may be required for the parent company and the consolidated banks in a multibank holding company, for separate subsidiaries (when appropriate), or for each significant foreign currency and global political entity, as necessary. These separate CFPs may be necessary because of legal requirements and restrictions, or the lack thereof. Institutions that have significant payment-system operations should have a formal, written plan in place for managing the risk of both intraday and end-of-day funding failures. Failures may occur as a result of system failure at the institution or at an institution from which payments are expected. Clear, formal communication channels should be established between the institution's operational areas responsible for handling payment-system operations.

### *Assessing Levels of Severity and Timing*

The CFP should delineate the various levels of stress severity that can occur during a contingent liquidity event and, for each type of event, identify the institution's response plan at each stage of an event. (As an event unfolds, it often progresses through various stages and levels of severity.) The events, stages, and severity levels identified should include those that cause temporary disruptions, as well as those that may cause intermediate- or longer-term disruptions.

Institutions can use the different stages or levels of severity to design early-warning indicators, assess potential funding needs at various points during a developing crisis, and specify comprehensive action plans.

### *Assessing Funding Needs and Sources of Liquidity*

A critical element of the CFP is an institution's quantitative projection and evaluation of its expected funding needs and funding capacity during a stress event. The institution should identify the sequence of responses that it will mobilize during a stress event and commit sources of funds for contingent needs well in advance of a stress-related event. To accomplish this objective, the institution needs to analyze potential erosion in its funding at alternative stages or severity levels of the stress event, as well as analyze the potential cash-flow mismatches that may occur during the various stress scenarios and levels. Institutions should base their analyses on realistic assessments of the behavior of funds providers during the event; they should also incorporate alternative contingency funding sources into their plans. The analysis should also include all material on- and OBS cash flows and their related effects, which should result in a realistic analysis of the institution's cash inflows, outflows, and funds availability at different time intervals throughout the potential liquidity stress event—and allow the institution to measure its ability to fund operations over an extended period.

Common tools to assess funding mismatches include

- *Liquidity-gap analysis*—A cash-flow report that essentially represents a base case estimate of where funding surpluses and shortfalls will occur over various future timeframes.
- *Stress tests*—A pro forma cash-flow report with the ability to estimate future funding surpluses and shortfalls under various liquidity stress scenarios and the institution's ability to fund expected asset growth projections or sustain an orderly liquidation of assets under various stress events.

### *Identify Potential Funding Sources*

Because of the potential for liquidity pressures to spread from one source of funding to another during a significant liquidity event, institutions should identify, well in advance, alternative sources of liquidity and ensure that they have ready access to contingent funding sources. These funding sources will rarely be used in the normal course of business. Therefore, institutions should conduct advance planning to ensure that contingent funding sources are readily available. For example, the sale, securitization, or pledging of assets as collateral requires a review of these assets to determine the appropriate haircuts and to ensure compliance with the standards required for executing the strategy. Administrative procedures and agreements should also be in place before the institution needs to access the planned source of liquidity. Institutions should identify what advance steps they need to take to promote the readiness of each of their sources of standby liquidity.

### *Processes for Managing Liquidity Events*

The CFP should identify a reliable crisis-management team and an administrative structure for responding to a liquidity crisis, including realistic action plans executing each element of the plan for each level of a stress event. Frequent communication and reporting among crisis team members, the board of directors, and other affected managers optimizes the effectiveness of a contingency plan by ensuring that business decisions are coordinated to minimize further liquidity disruptions. Effective management of a stress event requires the daily computation of regular liquidity-risk reports and supplemental information. The CFP should provide for more-frequent and more-detailed reporting as a stress situation intensifies. Reports that should be available in a funding crisis include—

- a CD breakage report to identify early redemptions of CDs;
- funding-concentration reports;
- cash-flow projections and run-off reports;
- funding-availability or -capacity reports, by types of funding; and
- reports on the status of contingent funding sources.



### *Framework for Monitoring Contingent Events*

Financial institutions should monitor for potential liquidity stress events by using early-warning indicators and event triggers. These indicators should be tailored to an institution's specific liquidity-risk profile. By recognizing potential stress events early, the institution can proactively position itself into progressive states of readiness as an event evolves. This proactive stance also provides the institution with a framework for reporting or communicating among different institutional levels and to outside parties. Early-warning signals may include but are not limited to—

- rapid asset growth that is funded with potentially volatile liabilities;
- growing concentrations in assets or liabilities;
- negative trends or heightened risk associated with a particular product line;
- rating-agency actions (e.g., agencies watch-listing the institution or downgrading its credit rating);
- negative publicity;
- significant deterioration in the institution's earnings, asset quality, and overall financial condition;
- widening debt or credit-default-swap spreads;
- difficulty accessing longer-term funding;
- increasing collateral margin requirements;
- rising funding costs in a stable market;
- increasing redemptions of CDs before maturity;
- counterparty resistance to OBS products;
- counterparties that begin requesting backup collateral for credit exposures; and
- correspondent banks that eliminate or decrease their credit lines.

To mitigate the potential for reputation contagion when liquidity problems arise, effective communication with counterparties, credit-rating agencies, and other stakeholders is of vital importance. Smaller institutions that rarely interact with the media should have plans in place for how they will manage press inquiries that may arise during a liquidity event. In addition, group-wide CFPs, liquidity cushions, and multiple sources of funding are mechanisms that may mitigate reputation concerns.

In addition to early-warning indicators, institutions that issue public debt, use warehouse financing, securitize assets, or engage in material OTC derivative transactions typically have

exposure to event triggers that are embedded in the legal documentation governing these transactions. These triggers protect the investor or counterparty if the institution, instrument, or underlying asset portfolio does not perform at certain predetermined levels. Institutions that rely upon brokered deposits should also incorporate PCA-related downgrade triggers into their CFPs since a change in PCA status could have a material bearing on the availability of this funding source. Contingent event triggers should be an integral part of the liquidity-risk monitoring system.

Asset-securitization programs pose heightened liquidity concerns because an early-amortization event could produce unexpected funding needs. Liquidity contingency plans should address this risk, if it is material to the institution. The unexpected funding needs associated with an early amortization of a securitization event pose liquidity concerns for the originating bank. The triggering of an early-amortization event can result in the securitization trust immediately passing principal payments through to investors. As the holder of the underlying assets, the originating institution is responsible for funding new charges that would normally have been purchased by the trust. Financial institutions that engage in asset securitization should have liquidity contingency plans that address this potential unexpected funding requirement. Management should receive and review reports showing the performance of the securitized portfolio in relation to the early-amortization triggers.<sup>2</sup>

Securitization covenants that cite supervisory thresholds or adverse supervisory actions as triggers for early-amortization events are considered an unsafe and unsound banking practice that undermines the objective of supervisory actions. An early amortization triggered by a supervisory action can create or exacerbate liquidity and earnings problems that can lead to further deterioration in the financial condition of the banking organization.<sup>3</sup>

Securitized asset-backed commercial paper programs (ABCPs) are generally supported by a liquidity facility or commitment to purchase assets from the trust if funds are

2. See sections 2130.1, 3020.1, and 4030.1, and the *OCC Handbook on Credit Card Lending*, October 1996.

3. SR-02-14, "Covenants in Securitization Documents Linked to Supervisory Actions or Thresholds."

needed to repay the underlying obligations. Liquidity needs can result from either cash-flow mismatches between the underlying assets and scheduled payments of the overriding security or from credit-quality deterioration of the underlying asset pool. Therefore, the use of liquidity facilities introduces additional risk to the institution, and a commensurate capital charge is required.<sup>4</sup>

Institutions that rely upon secured funding sources also are subject to potentially higher margin or collateral requirements that may be triggered upon the deterioration of a specific portfolio of exposures or the overall financial condition of the institution. The ability of a financially stressed institution to meet calls for additional collateral should be considered in the CFP. Potential collateral values also should be subject to stress tests since devaluations or market uncertainty could reduce the amount of contingent funding that can be obtained from pledging a given asset.

### *Testing the CFP*

Periodic testing of the operational elements of the CFP is an important part of liquidity-risk management. By testing the various operational elements of the CFP, institutions can prevent unexpected impediments or complications in accessing standby sources of liquidity during a contingent liquidity event. It is prudent to test the operational elements of a CFP that are associated with the securitization of assets, repurchase lines, Federal Reserve discount window borrowings, or other borrowings, since efficient collateral processing during a crisis is especially important for such sources. Institutions should carefully consider whether to include unsecured funding lines in their CFPs, since these lines may be unavailable during a crisis.

Larger, more-complex institutions can benefit from operational simulations that test communications, coordination, and decision-making of managers who have different responsibilities, who are in different geographic locations, or who are located at different operating subsidiaries. Simulations or tests run late in the day can highlight specific problems, such as late-day staffing deficiencies or difficulty selling assets or

borrowing new funds near the closing time of the financial markets.

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### **Internal Controls**

An institution's internal controls consist of policies, procedures, approval processes, reconciliations, reviews, and other types of controls to provide assurances that the institution manages liquidity risk in accordance with the board's strategic objectives and risk tolerances. Appropriate internal controls should address relevant elements of the risk-management process, including the institution's adherence to policies and procedures; the adequacy of its risk identification, risk measurement, and risk reporting; and its compliance with applicable rules and regulations. The results of reviews of the liquidity-risk management process, along with any recommendations for improvement, should be reported to the board of directors, which should take appropriate and timely action.

An important element of a bank's internal controls is management's comprehensive evaluation and review. Management should ensure that an independent party regularly reviews and evaluates the components of the institution's liquidity-risk management process. These reviews should assess the extent to which the institution's liquidity-risk management complies with both supervisory guidance and industry sound practices, taking into account the level of sophistication and complexity of the institution's liquidity-risk profile. In larger, complex institutions, an internal audit function usually performs this review. Smaller, less complex institutions may assign the responsibility for conducting an independent evaluation and review to qualified individuals who are independent of the function they are assigned to review. The independent review should report key issues requiring attention, including

4. SR-05-13, "Interagency Guidance on the Eligibility of ABCP Liquidity Facilities and the Resulting Risk-Based Capital Treatment."

instances of noncompliance, to the appropriate level of management to initiate a prompt correction of the issues, consistent with approved policies.

Periodic reviews of the liquidity-risk management process should address any significant changes that have occurred since the last review, such as changes in the institution's types or characteristics of funding sources, limits, and internal controls. Reviews of liquidity-risk measurement systems should include assessments of the assumptions, parameters, and methodologies used. These reviews should also seek to understand, test, and document the current risk-measurement process; evaluate the system's accuracy; and recommend solutions to any identified weaknesses.

Controls for changes to the assumptions the institution uses to make cash-flow projections should require that the assumptions not be altered without clear justification consistent with approved strategies. The name of the individual authorizing the change, along with the date of the change, the nature of the change, and justification for each change, should be fully documented. Documentation for all assumptions used in cash-flow projections should be maintained in a readily accessible, understandable, and auditable form. Because liquidity-risk measurement systems may incorporate one or more subsidiary systems or processes, institutions should ensure that multiple component systems are well integrated and consistent with each other.

## LIQUIDITY-RISK MANAGEMENT FOR BANK HOLDING COMPANIES

Bank holding companies (BHCs) should develop and maintain liquidity-risk management processes and funding programs that are consistent with their level of sophistication and complexity. For BHCs (includes financial holding companies, which are BHCs) see the *Bank Holding Company Supervision Manual*, section 4066, "Funding and Liquidity Risk Management," and sections 1050.0 and 1050.1, that discuss the consolidated supervision of BHCs. See also SR-10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management." Also see sections 4010.0, "Parent Only—Debt Servicing Capacity/Cash Flow" and 4010.2 "Parent Only—Liquidity."

## SUPERVISORY PROCESS FOR EVALUATING LIQUIDITY RISK

Liquidity risk is a primary concern for all banking organizations and is an integral component of the CAMELS rating system. Examiners should consider liquidity risk during the preparation and performance of all on-site safety-and-soundness examinations as well as during targeted supervisory reviews. To meet examination objectives efficiently and effectively and remain sensitive to potential burdens imposed on institutions, examiners should follow a structured, risk-focused approach for the examination of liquidity risk. Key elements of this examination process include off-site monitoring and a risk assessment of the institution's liquidity-risk profile. These elements will help the examiner develop an appropriate plan and scope for the on-site examination, thus ensuring the exam is as efficient and productive as possible. A fundamental tenet of the risk-focused examination approach is the targeting of supervisory resources at functions, activities, and holdings that pose the most risk to the safety and soundness of an institution.

For smaller institutions that have less complex liquidity profiles, stable funding sources, and low exposures to contingent liquidity circumstances, the liquidity element of an examination may be relatively simple and straightforward. On the other hand, if an institution is experiencing significant asset and product growth; is highly dependent on potentially volatile funds; or has a complex business mix, balance-sheet structure, or liquidity-risk profile that exposes the institution to contingent liquidity risks, that institution should generally receive greater supervisory attention. Given the contingent nature of liquidity risk, institutions whose corporate structure gives rise to inherent operational risk, or institutions encountering difficulties associated with their earnings, asset quality, capital adequacy, or market sensitivity, should be especially targeted for review of the adequacy of their liquidity-risk management.

### Off-Site Risk Assessment

In off-site monitoring and analysis, a preliminary view, or *risk assessment*, is developed before initiating an on-site examination. Both the inherent level of an institution's liquidity-

risk exposure and the quality of its liquidity-risk management should be assessed to the fullest extent possible during the off-site phase of the examination process. The following information can be helpful in this assessment:

- organizational charts and policies that identify authorities and responsibilities for managing liquidity risk
- liquidity policies, procedures, and limits
- ALCO committee minutes and reports (minutes and reports issued since the last examination or going back at least six to twelve months before the examination)
- board of directors reports on liquidity-risk exposures
- audit reports (both internal and external)
- other available internal liquidity-risk management reports, including cash-flow projections that detail key assumptions
- internal reports outlining funding concentrations, the marketability of assets, analysis that identifies the relative stability or volatility of various types of liabilities, and various cash-flow coverage ratios projected under adverse liquidity scenarios
- supervisory surveillance reports and supervisory screens
- external public debt ratings (if available)

Quantitative liquidity exposure should be assessed by conducting as much of the supervisory review off-site as practicable. This off-site work includes assessing the bank's overall liquidity-risk profile and the potential for other risk exposures, such as credit, market, operational, legal, and reputational risks, that may have a negative impact on the institution's liquidity under adverse circumstances. These assessments can be conducted on a preliminary basis using supervisory screens, examiner-constructed measures, internal bank measures, and cash-flow projections obtained from management reports received before the on-site engagement. Additional factors to be incorporated in the off-site risk assessment include the institution's balance-sheet composition and the existence of funding concentrations, the marketability of its assets (in the context of liquidation, securitization, or use of collateral), and the institution's access to secondary markets of liquidity.

The key to assessing the quality of management is an organized discovery process aimed at determining whether appropriate corporate-

governance structures, policies, procedures, limits, reporting systems, CFPs, and internal controls are in place. This discovery process should, in particular, ascertain whether all the elements of sound liquidity-risk management are applied consistently. The results and reports of prior examinations, in addition to internal management reports, provide important information about the adequacy of the institution's risk management.

## Examination Scope

The off-site risk assessment provides the examiner with a preliminary view of both the adequacy of liquidity management and the magnitude of the institution's exposure. The scope of the on-site liquidity-risk examination should be designed to confirm or reject the off-site hypothesis and should target specific areas of interest or concern. In this way, on-site examination procedures are tailored to the institution's activities and risk profile and use flexible and targeted work-documentation programs. In general, if liquidity-risk management is identified as adequate, examiners can rely more heavily on a bank's internal liquidity measures for assessing its inherent liquidity risk.

The examination scope for assessing liquidity risk should be commensurate with the complexity of the institution and consistent with the off-site risk assessment. For example, only baseline examination procedures would be used for institutions whose off-site risk assessment indicates that they have adequate liquidity-risk management processes and low levels of inherent liquidity exposure. These institutions include those that have noncomplex balance-sheet structures and banking activities and that also meet the following criteria:

- well capitalized; minimal issues with asset quality, earnings, and market-risk-sensitive activities
- adequate reserves of marketable securities that can serve as standby sources of liquidity
- minimal funding concentrations
- funding structures that are principally composed of stable liabilities
- few OBS items, such as loan commitments, that represent contingent liquidity draws
- minimal potential exposure to legal and reputational risk

- formal adoption of well-documented liquidity-management policies, procedures, and CFPs

For these and other institutions identified as potentially low risk, the scope of the on-site examination would consist of only those examination procedures necessary to confirm the risk-assessment hypothesis. The adequacy of liquidity-risk management could be verified through a basic review of the appropriateness of the institution's policies, internal reports, and controls and its adherence to them. The integrity and reliability of the information used to assess the quantitative level of risk could be confirmed through limited sampling and testing. In general, if basic examination procedures validate the risk assessment, the examiner may conclude the examination process.

High levels of inherent liquidity risk may arise if an institution has concentrations in specific business activities, products, and sectors, or if it has balance-sheet risks, such as unstable liabilities, risky assets, or planned asset growth without an adequate plan for funding the asset growth. OBS items that have uncertain cash inflows may also be a source of inherent liquidity risk. Institutions for which a risk assessment indicated high levels of inherent liquidity-risk exposure and strong liquidity management may require a more extensive examination scope to confirm the assessment. These expanded procedures may entail more analysis of the institution's liquidity-risk measurement system and its liquidity-risk profile. When high levels of liquidity-risk exposure are found, examiners should focus special attention on the sources of this risk. When a risk assessment indicates an institution has high exposure and weak risk-management systems, an extensive work-documentation program is required. The institution's internal measures should be used cautiously, if at all.

Regardless of the sophistication or complexity of an institution, examiners must use care during the on-site phase of an examination to confirm the off-site risk assessment and identify issues that may have escaped off-site analysis. Accordingly, the examination scope should be adjusted as on-site findings dictate.

## Assessing CAMELS “L” Ratings

The assignment of the “L” rating is integral to the CAMELS ratings process for commercial banks. Examination findings on both (1) the inherent level of an institution's liquidity risk and (2) the adequacy of its liquidity-risk management process should be incorporated in the assignment of the “L” rating. Findings on the adequacy of liquidity-risk management should also be reflected in the CAMELS “M” rating for risk management.

Examiners can develop an overall assessment of an institution's liquidity-risk exposure by reviewing the various characteristics of its assets, liabilities, OBS instruments, and material business activities. An institution's asset credit quality, earnings integrity, and market risk may also have significant implications for its liquidity-risk exposure. Importantly, assessments of the adequacy of an institution's liquidity-management practices may affect the assessment of its inherent level of liquidity risk. For institutions judged to have sound and timely liquidity-risk measurement and reporting systems and CFPs, examiners may use the results of the institution's adverse-scenario cash-flow projections in order to gain insight into its level of inherent exposure. Institutions that have less-than-adequate measurement and reporting systems and CFPs may have higher exposure to liquidity risk as a result of their potential inability to respond to adverse liquidity events.

Elements of strong liquidity-risk management are particularly important during stress events and include many of the items discussed previously: communication among the departments responsible for managing liquidity, reports that indicate a diversity of funding sources, standby funding sources, cash-flow analyses, liquidity stress tests, and CFPs. Liquidity-risk management should also manage the ongoing costs of maintaining liquidity.

Liquidity risk should be rated in accordance with the Uniform Financial Institutions Rating System (UFIRS).<sup>5</sup> The assessment of the adequacy of liquidity-risk management should provide the primary basis for reaching an overall assessment on the “L” component rating since it is a leading indicator of potential liquidity-risk exposure. Accordingly, overall ratings for liquidity-risk sensitivity should be no greater

5. SR-96-38, “Uniform Financial Institutions Rating System” and section A.5020.1.

than the rating given to liquidity-risk management.

In evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared with funding needs, as well as to the adequacy of funds-management practices relative to the institution's size, complexity, and risk profile. In general, funds-management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds-management practices should ensure that liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Liquidity is rated based upon, but not limited to, an assessment of the following evaluation factors:

- the adequacy of liquidity sources compared with present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition
- the availability of assets readily convertible to cash without undue loss
- access to money markets and other sources of funding
- the level of diversification of funding sources, both on- and off-balance-sheet
- the degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer-term assets
- the trend and stability of deposits
- the ability to securitize and sell certain pools of assets
- the capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds-management strategies, liquidity policies, management information systems, and CFPs

Ratings of liquidity-risk management should follow the general framework used to rate overall risk management:

- A rating of 1 indicates strong liquidity levels and well-developed funds-management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.
- A rating of 2 indicates satisfactory liquidity levels and funds-management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds-management practices.
- A rating of 3 indicates liquidity levels or funds-management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds-management practices.
- A rating of 4 indicates deficient liquidity levels or inadequate funds-management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.
- A rating of 5 indicates liquidity levels or funds-management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Unsafe liquidity-risk exposures and weaknesses in managing liquidity risk should be fully reflected in the overall liquidity-risk ratings. Unsafe exposures and unsound management practices that are not resolved during the on-site examination should be addressed through subsequent follow-up actions by the examiner and other supervisory personnel.

## REFERENCES

The following sources provide additional information on liquidity-risk management:

- *Bank Holding Company Supervision Manual*, Board of Governors of the Federal Reserve System.
- Basel Committee on Banking Supervision, "Sound Practices for Managing Liquidity in Banking Organisations," publication 69, February 2000.
- "Determining Conformance With Interest Rate

- Restrictions for Less Than Well Capitalized Institutions,” Federal Deposit Insurance Corporation, November 3, 2009 (FIL 62-2009)
- Federal Deposit Insurance Corporation, *Risk Management Manual of Examination Policies*, section 6.1—“Liquidity and Funds Management.”
  - Federal Financial Institutions Examination Council, Uniform Bank Performance Report.
  - Interagency Policy Statement on Funding and Liquidity Risk Management, March 17, 2010
  - Office of the Comptroller of the Currency, *Comptroller’s Handbook (Safety & Soundness)*, “Liquidity,” February 2001.
  - “Process for Determining If An Institution Subject to Interest-Rate Restrictions is Operating in a High-Rate Area,” Federal Deposit Insurance Corporation, December 4, 2009 (FIL 69-2009)
  - SR-01-08, “Supervisory Guidance on Complex Wholesale Borrowings,” Board of Governors of the Federal Reserve System, April 5, 2001.
  - SR-01-14, “Joint Agency Advisory on Rate-Sensitive Deposits,” Board of Governors of the Federal Reserve System, May 31, 2001.
  - SR-03-15, “Interagency Advisory on the Use of the Federal Reserve’s Primary Credit Program in Effective Liquidity Management,” Board of Governors of the Federal Reserve System, July 25, 2003.
  - SR-10-6, “Interagency Policy Statement on Funding and Liquidity-Risk Management,” Board of Governors of the Federal Reserve System, March 17, 2010.
  - *Trading and Capital-Markets Activities Manual*, Board of Governors of the Federal Reserve System.

extreme, highly granular cash-flow projections under alternative scenarios are used by both complex and noncomplex firms to manage their day-to-day funding mismatches in the normal course of business and for assessing their contingent liquidity-risk exposures. At the other end of the measurement spectrum, aggregate measures and various types of liquidity ratios are often employed to convey summary views of an institution’s liquidity-risk profile to various levels of management, the board of directors, and other stakeholders. As a result of this broad continuum, effective managers generally use a combination of cash-flow analysis and summary liquidity-risk measures in managing their liquidity-risk exposures, since no one measure or measurement technique can adequately capture the full dynamics of a financial institution’s liquidity-risk exposure.

This appendix provides background material on the basic elements of liquidity-risk measurement and is intended to enhance examiners’ understanding of the key elements of liquidity-risk management. First, the fundamental structure of cash-flow-projection worksheets and their use in assessing cash-flow mismatches under both normal business conditions and contingent liquidity events are discussed. The appendix then discusses the key liquidity characteristics of common depository institution assets, liabilities, off-balance-sheet (OBS) items, and other activities. These discussions also present key management considerations surrounding various sources and uses of liquidity in constructing cash-flow worksheets and addressing funding gaps under both normal and adverse conditions. Finally, commonly used summary liquidity measures and ratios are discussed, along with special considerations that should enter into the construction and use of these summary measures.<sup>6</sup>

## APPENDIX 1—FUNDAMENTALS OF LIQUIDITY-RISK MEASUREMENT

### I. Basic Cash-Flow Projections

Measuring a financial institution’s liquidity-risk profile and identifying alternative sources of funds to meet cash-flow needs are critical elements of sound liquidity-risk management. The liquidity-measurement techniques and the liquidity measures employed by depository institutions vary across a continuum of granularity, specificity, and complexity, depending on the specific characteristics of the institution and the intended users of the information. At one

In measuring an institution’s liquidity-risk profile, effective liquidity managers estimate cash inflows and cash outflows over future periods. For day-to-day operational purposes, cash-flow projections for the next day and subsequent days

<sup>6</sup> Material presented in this appendix draws from the OCC *Liquidity Handbook*, FDIC guidance, Federal Reserve guidance, findings from Federal Reserve supervision reviews, and other material developed for the Federal Reserve by consultants and other outside parties.

out over the coming week are used in order to ensure that contractual obligations are met on time. Such daily projections can be extended out beyond a one-week horizon, although it should be recognized that the further out such projections are made, the more susceptible they become to error arising from unexpected changes.

For planning purposes, effective liquidity managers project cash flows out for longer time horizons, employing various incremental time periods, or “buckets,” over a chosen horizon. Such buckets may encompass forward weeks, months, quarters, and, in some cases, years. For example, an institution may plan its cash inflows and outflows on a daily basis for the next 5–10 business days, on a weekly basis over the coming month or quarter, on a monthly basis over the coming quarter or quarters, and on a quarterly basis over the next half-year or year. Such cash-flow bucketing is usually compiled into a single cash-flow-projection worksheet or report that represents cash flows under a specific future scenario. The goal of this bucketing approach is a measurement system with sufficient granularity to (1) reveal the time dimension of the needs and sources of liquidity and (2) identify potential liquidity-risk exposure to contingent events.

In its most basic form, a cash-flow-projection worksheet is a table with columns denoting the selected time periods or buckets for which cash flows are to be projected. The rows of this table consist of various types of assets, liabilities, and OBS items, often grouped by their cash-flow characteristics. Different groupings may be used to achieve different objectives of the cash-flow projection. For each row, net cash flows arising from the particular asset, liability, or OBS activity are projected across the time buckets.

The detail and granularity of the rows, and thus the projections, depend on the sophistication and complexity of the institution. Complex banks generally favor more detail, while less complex banks may use higher levels of aggregation. Static projections based only on the contractual cash flows of assets, liabilities, and OBS items as of a point in time are helpful for identifying gaps between needs and sources of liquidity. However, static projections may inadequately quantify important aspects of potential liquidity risk because they ignore new business, funding renewals, customer options, and other potential events that may have a significant impact on the institution’s liquidity profile. Since liquidity managers are generally interested in

evaluating how available liquidity sources may cover both expected and potential unexpected liquidity needs, a dynamic analysis that includes management’s projected changes in cash flows is normally far more useful than a static projection based only on contractual cash flows as of a given projection date.

In developing a cash-flow-projection worksheet, cash inflows occurring within a given time horizon or time bucket are represented as positive numbers, while outflows are represented as negative numbers. Cash inflows include increases in liabilities as well as decreases in assets, and cash outflows include decreases in liabilities as well as increases in assets. For each type of asset, liability, or OBS item, and in each time bucket, the values shown in the cells of the projected worksheet are net cash-flow numbers. One format for a cash-flow-projection worksheet arrays sources of net cash inflows (such as loans and securities) in one group and sources of net cash outflows (such as deposit runoffs) in another. For example, the entries across time buckets for a loan or loan category would net the positives (cash inflows) of projected interest, scheduled principal payments, and prepayments with the negatives (cash outflows) of customer draws on existing commitments and new loan growth in each appropriate time bucket. Summing the net cash flows within a given column or time bucket identifies the extent of maturity mismatches that may exist. Funding shortfalls caused by mismatches in particular time frames are revealed as a “negative gap,” while excess funds within a time bucket denote a “positive gap.” Identifying such gaps early can help managers take the appropriate action to either fill a negative gap or reduce a positive gap. The subtotals of the net inflows and net outflows may also be used to construct net cash-flow coverage ratios or the ratio of net cash inflows to net cash outflows.

The specific worksheet formats used to array sources and uses of cash can be customized to achieve multiple objectives. Exhibit 1 provides an example of one possible form of a cash-flow-projection worksheet. The time buckets (columns) and sources and uses (rows) are selected for illustrative purposes, as the specific selection will depend on the purpose of the particular cash-flow projection. In this example, assets and liabilities are grouped into two broad categories: those labeled “customer-driven cash flows” and those labeled “management-controlled cash flows.” This grouping arrays projected cash



## Exhibit 1—Example Cash-Flow-Projection Worksheet

	<i>Day 1</i>	<i>Week 1</i>	<i>Week 2</i>	<i>Week 3</i>	<i>Month 1</i>	<i>Month 3</i>	<i>Months 4–6</i>	<i>Months 7–12</i>
<i>Customer-driven cash flows</i>								
Consumer loans								
Business loans								
Residential mortgage loans								
Fixed assets								
Other assets								
Noninterest-bearing deposits								
NOW accounts								
MMDAs								
Passbook savings								
Statement savings								
CDs under \$100,000								
Jumbo CDs								
Net noninterest income								
Miscellaneous and other liabilities								
Other								
Subtotal								
<i>Management-controlled cash flows</i>								
Investment securities								
Repos, FFP, & other short-term borrowings								
FHLB & other borrowings								
Committed lines								
Uncommitted lines								
Other								
Subtotal								
Net cash-flow gap								
Cumulative position								

flows on the basis of the relative extent to which funding managers may have control over changes in the cash flows of various assets, liabilities, OBS items, and other activities that have an impact on cash flow. For example, managers generally have less control over loan and deposit cash flows (e.g., changes arising from either growth or attrition) and more control over such items as fed funds sold, investment securities, and borrowings.

The net cash-flow gap illustrated in the next-to-the-last row of exhibit 1 is the sum of the net cash flows in each time-bucket column and reflects the funding gap that will have to be financed in that time period. For the daily time buckets, this gap represents the net overnight position that needs to be funded in the unsecured

short-term (e.g., fed funds) market. The final row of the exhibit identifies a cumulative net cash-flow gap, which is constructed as the sum of the net cash flows in that particular time bucket and all previous time buckets. It provides a running picture across time of the cumulative funding sources and needs of the institution. The worksheet presented in exhibit 1 is only one of many alternative formats that can be used in measuring liquidity gaps.

## II. Scenario Dependency of Cash-Flow Projections

Cash-flow-projection worksheets describe an institution's liquidity profile under an estab-

lished set of assumptions about the future.

The set of assumptions used in the cash-flow projection constitutes a specific scenario customized to meet the liquidity manager's objective for the forecast. Effective liquidity managers generally use multiple forecasts and scenarios to achieve an array of objectives over planning time horizons. For example, they may use three broad types of scenarios every time they make cash-flow projections: normal-course-of-business scenarios; short-term, institution-specific stress scenarios; and more-severe, intermediate-term, institution-specific stress scenarios. Larger, more complex institutions that engage in significant capital-markets and derivatives activities also routinely project cash flows for various systemic scenarios that may have an impact on the firm. Each scenario requires the liquidity manager to assess and plan for potential funding shortfalls. Importantly, no single cash-flow projection reflects the range of liquidity sources and needs required for advance planning.

Normal-course-of-business scenarios establish benchmarks for the "normal" behavior of cash flows of the institution. The cash flows projected for such scenarios are those the institution expects under benign conditions and should reflect seasonal fluctuations in loans or deposit flows. In addition, expected growth in assets and liabilities is generally incorporated to provide a dynamic view of the institution's liquidity needs under normal conditions.

Adverse, institution-specific scenarios are those that subject the institution to constrained liquidity conditions. Such scenarios are generally defined by first specifying the type of liquidity event to be considered and then identifying various levels or stages of severity for that type of event. For example, institutions that do not have publicly rated debt generally employ scenarios that entail a significant deterioration in the credit quality of their loan and security holdings. Institutions that have publicly rated debt generally include a debt-rating downgrade scenario in their CFPs. The downgrade of an institution's public debt rating might be specified as one type of event, with successively lower ratings grades, including below-investment-grade ratings, to identify increasing levels of severity. Each level of severity can be viewed as an individual scenario for planning purposes. Effective liquidity managers ensure that they choose potential adverse liquidity scenarios that entail appropriate degrees of severity and model cash flows consistent with each level

of stress. Events that limit access to important sources of funding are the most common institution-specific scenarios used.

The same type of cash-flow-projection worksheet format shown in exhibit 1 can be used for adverse, institution-specific scenarios. However, in making such cash-flow projections, some institutions find it useful to organize the accounts differently to accommodate a set of very different assumptions from those used in the normal-course-of-business scenarios. Exhibit 2 presents a format in which accounts are organized by those involving potential cash outflows and cash inflows. This format focuses the analysis first on liability erosion and potential off-balance-sheet draws, followed by an evaluation of the bank's ability to cover potential runoff, primarily from assets that can be sold or pledged. Funding sources are arranged by their sensitivity to the chosen scenario. For example, deposits may be segregated into insured and uninsured portions. The time buckets used are generally of a shorter term than those used under business-as-usual scenarios, reflecting the speed at which deteriorating conditions can affect cash flows.

A key goal of creating adverse-situation cash-flow projections is to alert management as to whether incremental funding resources available under the constraints of each scenario are sufficient to meet the incremental funding needs that result from that scenario. To the extent that projected funding deficits are larger than (or projected funding surpluses are smaller than) desired levels, management has the opportunity to adjust its liquidity position or develop strategies to bring the institution back within an acceptable level of risk.

Adverse systemic scenarios entail macroeconomic, financial market, or organizational events that can have an adverse impact on the institution and its funding needs and sources. Such scenarios are generally customized to the individual institution's funding characteristics and business activities. For example, an institution involved in clearing and settlement activities may choose to model a payments-system disruption, while a bank heavily involved in capital-markets transactions may choose to model a capital-markets disruption.

The number of cash-flow projections necessary to fully assess potential adverse liquidity scenarios can result in a wealth of information that often requires summarization in order to appropriately communicate contingent liquidity-risk exposure to various levels of management.

**Exhibit 2—Example Cash-Flow-Projection Worksheet—Liquidity Under an Adverse Scenario**

<i>Potential outflows/funding erosion</i>	<i>Day 1</i>	<i>Day 2</i>	<i>Days 3–7</i>	<i>Week 2</i>	<i>Week 3</i>	<i>Week 4</i>	<i>Month 2</i>	<i>Months 2+</i>
Federal funds purchased								
Uncollateralized borrowings (sub-debt, MTNs, etc.)								
Nonmaturity deposits:								
insured								
— Noninterest-bearing deposits								
— NOW accounts								
— MMDAs								
— Savings								
Nonmaturity deposits: uninsured								
— Retail CDs under \$100,000								
— Jumbo CDs								
— Brokered CDs								
— Miscellaneous and other liabilities								
<b>Subtotal</b>								
<i>Off-balance-sheet funding requirements</i>								
Loan commitments								
Amortizing securitizations								
Out-of-the-money derivatives								
Backup lines								
<b>Total potential outflows</b>								
<i>Potential sources to cover outflows</i>								
Overnight funds sold								
Unencumbered investment securities (with appropriate haircut)								
Residential mortgage loans								
Consumer loans								
Business loans								
Fixed/other assets								
Unsecured borrowing capacity								
Brokered-funds capacity								
<b>Total potential inflows</b>								
<b>Net cash flows</b>								
<b>Coverage ratio (inflows/outflows)</b>								
<b>Cumulative coverage ratio</b>								

### Exhibit 3—Example Summary Contingent-Liquidity-Exposure Report (for an Assumed Time Horizon)

<i>Events:</i>	<i>Current</i>	<i>Ratings downgrade</i>		<i>Earnings</i>	<i>Reputation</i>	<i>Other (?)</i>
		<i>1 category</i>	<i>BBB to BB</i>			
<i>Scenarios:</i>				<i>RoA = ?</i>		
<i>Potential funding erosion</i>						
Large fund providers	—	—	—	—	—	—
Fed funds	—	—	—	—	—	—
CDs	—	—	—	—	—	—
Eurotakings/foreign deposits	—	—	—	—	—	—
Commercial paper	—	—	—	—	—	—
Subtotal	—	—	—	—	—	—
Other funds providers						
Fed funds	—	—	—	—	—	—
CDs	—	—	—	—	—	—
Eurotakings/foreign deposits	—	—	—	—	—	—
Commercial paper	—	—	—	—	—	—
DDAs	—	—	—	—	—	—
Consumer MMDAs	—	—	—	—	—	—
Savings	—	—	—	—	—	—
Other	—	—	—	—	—	—
Total uninsured funds	—	—	—	—	—	—
Total insured funds	—	—	—	—	—	—
Total funding	—	—	—	—	—	—
<i>Off-balance-sheet needs</i>						
Letters of credit	—	—	—	—	—	—
Loan commitments	—	—	—	—	—	—
Securizations	—	—	—	—	—	—
Derivatives	—	—	—	—	—	—
Total OBS items	—	—	—	—	—	—
Total funding erosion	—	—	—	—	—	—
<i>Sources of funds</i>						
Surplus money market	—	—	—	—	—	—
Unpledged securities	—	—	—	—	—	—
Securizations						
Credit cards	—	—	—	—	—	—
Autos	—	—	—	—	—	—
Mortgages	—	—	—	—	—	—
Loan sales	—	—	—	—	—	—
Other	—	—	—	—	—	—
Total internal sources	—	—	—	—	—	—
Borrowing capacity	—	—	—	—	—	—
Brokered-funds capacity	—	—	—	—	—	—
Fed discount borrowings	—	—	—	—	—	—
Other	—	—	—	—	—	—

Exhibit 3 presents an example of a report format that assesses available sources of liquidity under alternative scenarios. The worksheet shows the amount of anticipated funds erosion and potential sources of funds under a number of stress scenarios, for a given time bucket (e.g., overnight, one week, one month, etc.). In this example, two rating-downgrade scenarios of different severity are used, along with a scenario built on low-earnings projections and a potential reputational-risk scenario.

Exhibit 4 shows an alternative format for summarizing the results of multiple scenarios. In this case, summary funding gaps are presented across various time horizons (columns) for each scenario (rows). Actual reports used should be tailored to the specific liquidity-risk profile and other institution-specific characteristics.

### III. Liquidity Characteristics of Assets, Liabilities, Off-Balance-Sheet Positions, and Various Types of Banking Activities

A full understanding of the liquidity and cash-flow characteristics of the institution's assets, liabilities, OBS items, and banking activities is critical to the identification and management of mismatch risk, contingent liquidity risk, and market liquidity risk. This understanding is required for constructing meaningful cash-flow-projection worksheets under alternative scenarios, for developing and executing strategies used in managing mismatches, and for customizing summary liquidity measures or ratios.

#### A. Assets

The generation of assets is one of the primary uses of funds at banking organizations. Once acquired, assets provide cash inflows through principal and interest payments. Moreover, the liquidation of assets or their use as collateral for borrowing purposes makes them an important source of funds and, therefore, an integral tool in managing liquidity risk. As a result, the objectives underlying an institution's holdings of various types of assets range along a continuum that balances the tradeoffs between maximizing risk-adjusted returns and ensuring the fulfillment of an institution's contractual obligations

to deliver funds (ultimately in the form of cash). Assets vary by structure, maturity, credit quality, marketability, and other characteristics that generally reflect their relative ability to be convertible into cash.

Cash operating accounts that include vault cash, cash items in process, correspondent accounts, accounts with the Federal Reserve, and other cash or "near-cash" instruments are the primary tools institutions use to execute their immediate cash-transaction obligations. They are generally not regarded as sources of additional or incremental liquidity but act as the operating levels of cash necessary for executing day-to-day transactions. Accordingly, well-managed institutions maintain ongoing balances in such accounts to meet daily business transactions. Because they generate no or very low interest earnings, such holdings are generally maintained at the minimum levels necessary to meet day-to-day transaction needs.

Beyond cash and near-cash instruments, the extent to which assets contribute to an institution's liquidity profile and the management of liquidity risk depends heavily on the contractual and structural features that determine an asset's cash-flow profile, its marketability, and its ability to be pledged to secure borrowings. The following sections discuss important aspects of these asset characteristics that effective managers factor into their management of liquidity risk on an ongoing basis and during adverse liquidity events.

*Structural cash-flow attributes of assets.* Knowledge and understanding of the contractual and structural features of assets, such as their maturity, interest and amortization payment schedules, and any options (either explicit or embedded) that might affect contractual cash flows under alternative scenarios, is critical for the adequate measurement and management of liquidity risk. Clearly, the maturity of assets is a key input in cash-flow analysis. Indeed, the management of asset maturities is a critical tool used in matching expected cash outflows and inflows. This matching is generally accomplished by "laddering" asset maturities in order to meet scheduled cash needs out through short and intermediate time horizons.

Short-term money market assets (MMAs) are the primary "laddering" tools used to meet funding gaps over short-term time horizons. They provide vehicles for institutions to ensure future cash availability while earning a return.

### Exhibit 4—Example Summary Contingent-Liquidity-Exposure Report (Across Various Time Horizons)

	<i>Projected liquidity cushion</i>				
	1 week	2–4 weeks	2 months	3 months	4+ months
<i>Normal course of business</i>					
Total cash inflows	—	—	—	—	—
Total cash outflows	—	—	—	—	—
Liquidity cushion (shortfall)	—	—	—	—	—
Liquidity coverage ratio	—	—	—	—	—
<i>Mild institution-specific</i>					
Total cash inflows	—	—	—	—	—
Total cash outflows	—	—	—	—	—
Liquidity cushion (shortfall)	—	—	—	—	—
Liquidity coverage ratio	—	—	—	—	—
<i>Severe institution-specific</i>					
Total cash inflows	—	—	—	—	—
Total cash outflows	—	—	—	—	—
Liquidity cushion (shortfall)	—	—	—	—	—
Liquidity coverage ratio	—	—	—	—	—
<i>Severe credit crunch</i>					
Total cash inflows	—	—	—	—	—
Total cash outflows	—	—	—	—	—
Liquidity cushion (shortfall)	—	—	—	—	—
Liquidity coverage ratio	—	—	—	—	—
<i>Capital-markets disruption</i>					
Total cash inflows	—	—	—	—	—
Total cash outflows	—	—	—	—	—
Liquidity cushion (shortfall)	—	—	—	—	—
Liquidity coverage ratio	—	—	—	—	—
<i>Custom scenario</i>					
Total cash inflows	—	—	—	—	—
Total cash outflows	—	—	—	—	—
Liquidity cushion (shortfall)	—	—	—	—	—
Liquidity coverage ratio	—	—	—	—	—

Given the relatively low return on such assets, managers face important tradeoffs between earnings and the provision of liquidity in deploying such assets. In general, larger institutions employ a variety of MMAs in making such tradeoffs, while smaller community organizations face fewer potential sources of short-term investments.

The contractual and structural features, such as the maturity and payment streams of all financial assets, should be factored into both cash-flow projections and the strategies developed for filling negative funding gaps. This

practice includes the assessment of embedded options in assets that can materially affect an asset's cash flow. Effective liquidity managers incorporate the expected exercise of options in projecting cash flows for the various scenarios they use in measuring liquidity risk. For example, normal "business as usual" projections may include an estimate of the expected amount of loan and security principal prepayments under prevailing market interest rates, while alternative-scenario projections may employ estimates of expected increases in prepayments (and cash

flows) arising from declining interest rates and expected declines in prepayments or “maturity extensions” resulting from rising market interest rates.

*Market liquidity, or the “marketability” of assets.* Marketability is the ability to convert an asset into cash through a quick “sale” and at a fair price. This ability is determined by the market in which the sale transaction is conducted. In general, investment-grade securities are more marketable than loans or other assets. Institutions generally view holdings of investment securities as a first line of defense for contingency purposes, but banks need to fully assess the marketability of these holdings. The availability and size of a bid-asked spread for an asset provides a general indication of the market liquidity of that asset. The narrower the spread, and the deeper and more liquid the market, the more likely a seller will find a willing buyer at or near the asked price. Importantly, however, the market liquidity of an asset is not a static attribute but is a function of conditions prevailing in the secondary markets for the particular asset. Bid-asked spreads, when they exist, generally vary with the volume and frequency of transactions in the particular type of assets. Larger volumes and greater frequency of transactions are generally associated with narrower bid-asked spreads. However, disruptions in the marketplace, contractions in the number of market makers, the execution of large block transactions in the asset, and other market factors may result in the widening of the bid-asked spread—and thus reduce the market liquidity of an instrument. Large transactions, in particular, can constrain the market liquidity of an asset, especially if the market for the asset is not deep.

The marketability of assets may also be constrained by the volatility of overall market prices and the underlying rates, which may cause widening bid-asked spreads on marketable assets. Some assets may be more subject to this type of market volatility than others. For example, securities that have inherent credit or interest-rate risk can become more difficult to trade during times when market participants have a low tolerance for these risks. This may be the case when market uncertainties prompt investors to shun risky securities in favor of more-stable investments, resulting in a so-called flight to quality. In a flight to quality, investors become much more willing to sacrifice yield in exchange for safety and liquidity.

In addition to reacting to prevailing market conditions, the market liquidity of an asset can be affected by other factors specific to individual investment positions. Small pieces of security issues, security issues from nonrated and obscure issuers, and other inactively traded securities may not be as liquid as other investments. While brokers and dealers buy and sell inactive securities, price quotations may not be readily available, or when they are, bid-asked spreads may be relatively wide. Bids for such securities are unlikely to be as high as the bids for similar but actively traded securities. Therefore, even though sparsely traded securities can almost always be sold, an unattractive price can make the seller unenthusiastic about selling or result in potential losses in order to raise cash through the sale of an asset.

Accounting conventions can also affect the market liquidity of assets. For example, Accounting Standards Codification (ASC) 320, “Investments—Debt and Equity Securities,” (or Statement of Financial Accounting Standards No. 115 (FAS 115)) requires investment securities to be categorized as held-to-maturity (HTM), available-for-sale (AFS), or trading, significantly affects the liquidity characteristics of investment holdings. Of the three categories, securities categorized as HTM provide the least liquidity, as they cannot be sold to meet liquidity needs without potentially onerous repercussions.<sup>7</sup>

Securities categorized as AFS can be sold at any time to meet liquidity needs, but care must be taken to avoid large swings in earnings or triggering impairment recognition of securities with unrealized losses.

Trading account securities are generally considered the most marketable from an accounting standpoint, since selling a trading account investment has little or no income effect.

While securities are generally considered to have greater market liquidity than loans and other assets, liquidity-risk managers increasingly consider the ability to obtain cash from the sale of loans as a potential source of liquidity. Many types of bank loans can be sold, securitized, or pledged as collateral for borrowings. For example, the portions of loans that are insured or guaranteed by the U.S. government or by U.S. government-sponsored enterprises

7. HTM securities can be pledged, however, so they do still provide a potential source of liquidity. Furthermore, since the HTM-sale restriction is only an accounting standard (FAS 115)—not a market limitation—HTM securities can be sold in cases of extreme need.

are readily saleable under most market conditions. From a market liquidity perspective, the primary difference between loans and securities is that the process of turning loans into cash can be less efficient and more time-consuming. While securitizations of loan portfolios (discussed below) are more common in practice, commercial loans and portfolios of mortgages or retail loans can be, and often are, bought and sold by banking organizations. However, the due diligence and other requirements of these transactions generally take weeks or even months to complete, depending on the size and complexity of the loans being sold. Liquidity-risk managers may include selling marketable loans as a potential source of cash in their liquidity analyses, but they must be careful to realistically time the expected receipt of cash and should carefully consider past experience and market conditions at the expected time of sale. Institutions that do not have prior experience selling a loan or a mortgage portfolio often need more time to close a loan sale than does an institution that makes such transactions regularly. Additionally, in systemic liquidity or institution-specific credit-quality stress scenarios, the ability to sell loans outright may not be a realistic assumption.

Securitization can be a valuable method for converting otherwise illiquid assets into cash. Advances in the capital markets have made residential mortgage, credit card, student, home equity, automobile, and other loan types increasingly amenable to securitization. As a result, the securitization of loans has become an important funds-management tool at many depository institutions. Many institutions have business lines that originate assets specifically for securitization in the capital markets. However, while securitization can play an important role in managing liquidity, it can also increase liquidity risk—especially when excessive reliance is placed on securitization as a single source of funding.

Securitization can be regarded as an ongoing, reliable source of liquidity only for institutions that have experience in securitizing the specific type of loans under consideration. The time and effort involved in structuring loan securitizations make them difficult to use as a source of asset liquidity for institutions that have limited experience with this activity. Moreover, peculiarities involved in the structures used to securitize certain types of assets may introduce added complexity in managing an institution's

cash flows. For example, the securitization of certain retail-credit receivables requires planning for the possible return of receivable balances arising from scheduled or early amortization, which may entail the funding of sizable balances at unexpected or inopportune times. Institutions using securitization as a source of funding should have adequate monitoring systems and ensure that such activities are fully incorporated into all aspects of their liquidity-risk management processes—which includes assessing the liquidity impact of securitizations under adverse scenarios. This assessment is especially important for institutions that originate assets specifically for securitization since market disruptions have the potential to impose the need for significant contingent liquidity if securitizations cannot be executed. As a result, effective liquidity managers ensure that the implications of securitization activities are fully considered in both their day-to-day liquidity management and their liquidity contingency planning.

*Pledging of assets to secure borrowings.* The potential to pledge securities, loans, or other assets to obtain funds is another important tool for converting assets into cash to meet funding needs. Since the market liquidity of assets is a significant concern to the lender of secured funds, assets with greater market liquidity are more easily pledged than less marketable assets. An institution that has a largely unpledged investment-securities portfolio has access to liquidity either through selling the investments outright or through pledging the investments as collateral for borrowings or public deposits. However, once pledged, assets are generally unavailable for supplying contingent liquidity through their sale. When preparing cash-flow projections, liquidity-risk managers do not classify pledged assets as “liquid assets” that can be sold to generate cash since the liquidity available from these assets has already been “consumed” by the institution. Accordingly, when computing liquidity measures, effective liquidity managers avoid double-counting unpledged securities as both a source of cash from the potential sale of the asset and as a source of new liabilities from the potential collateralization of the the same security. In more-sophisticated cash-flow projections, the tying of the pledged asset to the funding is made explicit.

Similar to the pledging of securities, many investments can be sold under an agreement to repurchase. This agreement provides the institu-



tion with temporary cash without having to sell the investment outright and avoids the potential earnings volatility and transaction costs that buying and selling securities would entail.

*Use of haircuts in measuring the funds that can be raised through asset sales, securitizations, or repurchase agreements.* The planned use of asset sales, asset securitizations, or collateralized borrowings to meet liquidity needs necessarily involves some estimation of the value of the asset at the future point in time when the asset is anticipated to be converted into cash. Based on changes in market factors, future asset values may be more or less than current values. As a result, liquidity managers generally apply discounts, or *haircuts*, to the current value of assets to represent a conservative estimate of the anticipated proceeds available from asset sales or securitization in the capital markets. Similarly, lenders in secured borrowings also apply haircuts to determine the amount to lend against pledged collateral as protection if the value of that collateral declines. In this case, the haircut represents, in addition to other factors, the portion of asset value that cannot be converted to cash because secured lenders wish to have a collateral-protection margin.

When computing cash-flow projections under alternative scenarios and developing plans to meet cash shortfalls, liquidity managers ensure that they incorporate haircuts in order to reflect the market liquidity of their assets. Such haircuts are applied consistent with both the relative market liquidity of the assets and the specific scenario utilized. In general, longer-term, riskier assets, as well as assets with less liquid markets, are assigned larger haircuts than are shorter-term, less risky assets. For example, within the securities portfolio, different haircuts might be assigned to short-term and long-term Treasuries, rated and unrated municipal bonds, and different types of mortgage securities (e.g., pass-throughs versus CMOs). When available and appropriate, historical price changes over specified time horizons equal to the time until anticipated liquidation or the term of a borrowing are used by liquidity-risk managers to establish such haircuts. Haircuts used by nationally recognized statistical ratings organizations (NRSROs) are a starting point for such calculations but should not be unduly relied on since institution- and scenario-specific considerations may have important implications.

Haircuts should be customized to the particular projected or planned scenario. For example, adverse scenarios that hypothesize a capital-markets disruption would be expected to use larger haircuts than those used in projections assuming normal markets. Under institution-specific, adverse scenarios, certain assets, such as loans anticipated for sale, securitization, or pledging, may merit higher haircuts than those used under normal business scenarios. Institutions should fully document the haircuts they use to estimate the marketability of their assets.

Bank-owned life insurance (BOLI) is a popular instrument offering tax benefits as well as life insurance on bank employees. Some BOLI policies are structured to provide liquidity; however, most BOLI policies only generate cash in the event of a covered person's death and impose substantial fees if redeemed. In general, BOLI should not be considered a liquid asset. If it is included as a potential source of funds in a cash-flow analysis, a severe haircut reflecting the terms of the BOLI contract and current market conditions should be applied.

*Liquid assets and liquidity reserves.* Sound practices for managing liquidity risk call for institutions to maintain an adequate reserve of liquid assets to meet both normal and adverse liquidity situations. Such reserves should be structured consistent with the considerations discussed above regarding the marketability of different types of assets. Many institutions identify a specific portion of their investment account to serve as a liquidity reserve, or *liquidity warehouse*. The size of liquidity reserves should be based on the institution's assessments of its liquidity-risk profile and potential liquidity needs under alternative scenarios, giving full consideration to the costs of maintaining those assets. In general, the amount of liquid assets held will be a function of the stability of the institution's funding structures and the potential for rapid loan growth. If the sources of funds are stable, if adverse-scenario cash-flow projections indicate adequate sources of contingent liquidity (including sufficient sources of unused borrowing capacity), and if asset growth is predictable, then a relatively low asset liquidity reserve may be required. The availability of the liquidity reserves should be tested from time to time. Of course, liquidity reserves should be actively managed to reflect the liquidity-risk profile of the institution and current trends that might have

a negative impact on the institution's liquidity, such as—

- trading market, national, or financial market trends that might lead rate-sensitive customers to pursue investment alternatives away from the institution;
- significant actual or planned growth in assets;
- trends evidencing a reduction in large liability accounts;
- a substantial portion of liabilities from rate-sensitive and credit-quality-sensitive customers;
- significant liability concentrations by product type or by large deposit account holders;
- a loan portfolio consisting of illiquid, nonmarketable, or unpledgeable loans;
- expectations for substantial draws on loan commitments by customers;
- significant loan concentrations by product, industry, customer, and location;
- significant portions of assets pledged against wholesale borrowings; and
- impaired access to the capital markets.

### *B. Liabilities*

Similar to its assets, a depository institution's liabilities present a complicated array of liquidity characteristics. Banking organizations obtain funds from a wide variety of sources using an array of financial instruments. The primary characteristics that determine a liability's liquidity-risk profile include its term, optionality, and counterparty risk tolerance (which includes the counterparty's need for insurance or collateral). These features help to determine if an individual liability can be considered as stable or volatile. A stable liability is a reliable source of funds that is likely to remain available in adverse circumstances. A volatile liability is a less stable source of funds that may disappear or be unavailable to the institution under heavy price competition, deteriorating credit or market-risk conditions, and other possible adverse events. Developing assumptions on the relative stability or volatility of liabilities is a crucial step in forecasting a bank's future cash flows under various scenarios and in constructing various summary liquidity measures. As a result, effective liquidity managers segment their liabilities into volatile and stable components on the basis of the characteristics of the liability and on the risk

tolerance of the counterparty. These funds may be characterized as credit-sensitive, rate-sensitive, or both.

*Characteristics of stability and risk tolerance.* The stability of an individual bank liability is closely related to the customer's or counterparty's risk tolerance, or its willingness and ability to lend or deposit money for a given risk and reward. Several factors affect the stability and risk tolerance of funds providers, including the fiduciary responsibilities and obligations of funds providers to their customers, the availability of insurance on the funds advanced by customers to banking organizations, the reliance of customers on public debt ratings, and the relationships funds providers have with the institution.

Institutional providers of funds to banking organizations, such as money market funds, mutual funds, trust funds, public entities, and other types of investment managers, have fiduciary obligations and responsibilities to adequately assess and monitor the relative risk-and-reward tradeoffs of the investments they make for their customers, participants, or constituencies. These fund providers are especially sensitive to receiving higher returns for higher risk, and they are more apt to withdraw funds if they sense that an institution has a deteriorating financial condition. In general, funds from sources that lend or deposit money on behalf of others are less stable than funds from sources that lend their own funds. For example, a mutual fund purchaser of an institution's negotiable CD may be expected to be less stable than a local customer buying the same CD.

Institutionally placed funds and other funds providers often depend on the published evaluations or ratings of NRSROs. Indeed, many such funds providers may have bylaws or internal guidelines that prohibit placing funds with institutions that have low ratings or, in the absence of actual guidelines, may simply be averse to retaining funds at an institution whose rating is poor or whose financial condition shows deterioration. As a result, funds provided by such investors can be highly unstable in adverse liquidity environments.

The availability of insurance on deposits or collateral on borrowed funds are also important considerations in gauging the stability of funds provided. Insured or collateralized funds are usually more stable than uninsured or unsecured funds since the funds provider ultimately relies

on a third party or the value of collateral to protect its investment.

Clearly, the nature of a customer's relationship with an institution has significant implications for the potential stability or volatility of various sources of funds. Customers who have a long-standing relationship with an institution and a variety of accounts, or who otherwise use multiple banking services at the institution, are usually more stable than other types of customers.

Finally, the sensitivity of a funds provider to the rates paid on the specific instrument or transaction used by the banking organization to access funds is also critical for the appropriate assessment of the stability or volatility of funds. Customers that are very rate-driven are more likely not to advance funds or remove existing funds from an institution if more competitive rates are available elsewhere.

All of these factors should be analyzed for the more common types of depositors and funds providers and for the instruments they use to place funds with the institution. Such assessments lead to general conclusions regarding each type of customer's or counterparty's risk sensitivity and the stability of the funds provided by the instruments they use to place funds with the institution. Exhibit 5 provides a heuristic schematic of how effective liquidity-risk managers conduct such an assessment regarding the array of their different funds providers. It uses a continuum to indicate the general level of risk sensitivity (and thus the expected stability of funds) expected for each type of depositor, customer, or investor in an institution's debt obligations. Of course, individual customers and counterparties may have various degrees of such concerns, and greater granularity is generally required in practice. An additional instrument assessment of the stability or volatility of funds raised using that instrument from each type of fund provider is a logical next step in the process of evaluating the relative stability of various sources of funds to an institution.

There are a variety of methods used to assess the relative stability of funds providers. Effective liquidity managers generally review deposit accounts by counterparty type, e.g., consumer, small business, or municipality. For each type, an effective liquidity manager evaluates the applicability of risk or stability factors, such as whether the depositor has other relationships with the institution, whether the depositor owns the funds on deposit or is acting as an agent or manager, or whether the depositor is likely to be

more aware of and concerned by adverse news reports. The depositors and counterparties considered to have a significant relationship with the institution and who are less sensitive to market interest rates can be viewed as providing *stable* funding. Statistical analysis of funds volatility is often used to separate total volumes into stable and nonstable segments. While such analysis can be very helpful, it is important to be mindful that historical volatility is unlikely to include a period of acute liquidity stress.

The following discussions identify important considerations that should be factored into the assessment of the relative stability of various sources of funds utilized by banking organizations.

*Maturity of liabilities used to gather funds.* An important factor in assessing the stability of funds sources is the remaining contractual life of the liability. Longer-maturity liabilities obviously provide more-stable funding than do shorter maturities. Extending liability maturities to reduce liquidity risk is a common management technique and an important sound practice used by most depository institutions. It is also a major part of the cost of liquidity management, since longer-term liabilities generally require higher interest rates than are required for similar short-term liabilities.

*Indeterminate maturity deposits.* Evaluations of the stability of deposits with indeterminate maturities, such as various types of transaction accounts (e.g., demand deposits, negotiable order of withdrawal accounts (NOWs) or money market demand accounts (MMDAs), and savings accounts) can be made using criteria similar to those shown in exhibit 5. In doing so, effective liquidity managers recognize that the relative stability or volatility of these accounts derives from the underlying characteristics of the customers that use them and not on the account type itself. As a result, most institutions delineate the relative volatility or stability of various subgroups of these account types on the basis of customer characteristics. For example, MMDA deposits of customers who have fiduciary obligations may be less stable than those of individual retail customers. Additionally, funds acquired through a higher pricing strategy for these types of deposit accounts are generally less stable than are deposits from customers who have long-standing relationships with the institution. Increasingly, liquidity managers recog-

## Exhibit 5—General Characteristics of Stable and Volatile Liabilities

<i>Types of funds providers</i>	<i>Characteristics of funds providers that affect the stability/volatility of the funds provided</i>				
	<i>Fiduciary agent or own funds</i>	<i>Insured or secured</i>	<i>Reliance on public information</i>	<i>Relationship</i>	<i>Stability assessment</i>
Consumers	owner	yes	low	high	high
Small business	owner	in part	low	high	medium
Large corporate	owner	no	medium	medium	low
Banks	agent	no	high	medium	medium
Municipalities	agent	in part	high	medium	medium
Money market mutual funds	quasi-fiduciary	no	high	low	low
Other	—	—	—	—	—

nize that traditional measures of “core” deposits may be inappropriate, and thus these deposits require more in-depth analysis to determine their relative stability.

Assessment of the relative stability or volatility of deposits that have indeterminate maturities can be qualitative as well as quantitative, consistent with the size, complexity, and sophistication of the institution. For example, at larger institutions, models based on statistical analysis can be used to estimate the stability of various subsets of such funds under alternative liquidity environments. Such models can be used to formulate expected behaviors in reaction to rate changes and other more-typical financial events. As they do when using models to manage any type of risk, institutions should fully document and understand the assumptions and methodologies used. This is especially the case when external parties conduct such analysis. Effective liquidity managers aggressively avoid “black-box” estimates of funding behaviors.

In most cases, insured deposits from consumers may be less likely to leave the institution under many liquidity circumstances than are funds supplied by more-institutional funds providers. Absent extenuating circumstances (e.g., the deposit contract prohibits early withdrawal), funds provided by agents and fiduciaries are generally treated by banking organizations as volatile liabilities.

*Certificates of deposit and time deposits.* At maturity, certificates of deposit (CDs) and time deposits are subject to the general factors regarding stability and volatility discussed above, including rate sensitivity and relationship factors. Nonrelationship and highly-rate-sensitive

deposits tend to be less stable than deposits placed by less-rate-sensitive customers who have close relationships with the institution. Insured CDs are generally considered more stable than uninsured “jumbo” CDs in denominations of more than \$100,000. In general, jumbo CDs and negotiable CDs are more volatile sources of funds—especially during times of stress—since they may be less relationship-driven and have a higher sensitivity to potential credit problems.

*Brokered deposits and other rate-sensitive deposits.* Brokered deposits are funds a bank obtains, directly or indirectly, by or through any deposit broker, for deposit into one or more accounts. Thus, brokered deposits include both those in which the entire beneficial interest in a given bank deposit account or instrument is held by a single depositor and those in which the deposit broker pools funds from more than one investor for deposit in a given bank deposit account. Rates paid on brokered deposits are often higher than those paid for local-market-area retail deposits since brokered-deposit customers are generally focused on obtaining the highest FDIC-insured rate available. These rate-sensitive customers have easy access to, and are frequently well informed about, alternative markets and investments, and they may have no other relationship with or loyalty to the bank. If market conditions change or more-attractive returns become available, these customers may rapidly transfer their funds to new institutions or investments. Accordingly, these rate-sensitive depositors may exhibit characteristics more typical of wholesale investors, and liquidity-risk managers should model brokered deposits accordingly.

The use of brokered deposits is governed by

law and covered by the 2001 Joint Agency Advisory on Brokered and Rate-Sensitive Deposits.<sup>8</sup> Under 12 USC 1831f and 12 CFR 337.6, determination of “brokered” status is based initially on whether a bank actually obtains a deposit directly or indirectly through a deposit broker. Banks that are considered only “adequately capitalized” under the “prompt corrective action” (PCA) standard must receive a waiver from the FDIC before they can accept, renew, or roll over any brokered deposit. They are also restricted in the rates they may offer on such deposits. Banks falling below the adequately capitalized range may not accept, renew, or roll over any brokered deposit, nor solicit deposits with an effective yield more than 75 basis points above the “national rate.” The national rate is defined as “a simple average of rates paid by all insured depository institutions and branches for which data are available.” On a weekly basis, the “national rate” is posted on the FDIC’s website. If a depository institution believes that the “national rate” does not correspond to the actual prevailing rate in the applicable market, the institution may seek a determination from the FDIC that the institution is operating in a “high-rate area.” If the FDIC makes such a determination, the bank will be allowed to offer the actual prevailing rate plus 75 basis points. In any event, for deposits accepted outside the applicable market area, the bank will not be allowed to offer rates in excess of the “national rate” plus 75 basis points.

These restrictions will reduce the availability of funding alternatives as a bank’s condition deteriorates. The FDIC is not authorized to grant waivers for banks that are less than adequately capitalized. Bank managers who use brokered deposits should be familiar with the regulations governing brokered deposits and understand the requirements for requesting a waiver. Further detailed information regarding brokered deposits can be found in the FDIC’s Financial Institution Letter (FIL), 69-2009.

Deposits attracted over the Internet, through CD listing services, or through special advertising programs that offer premium rates to customers who do not have another banking relationship with the institution also require special monitoring. Although these deposits may not

fall within the technical definition of “brokered” in 12 USC 1831f and 12 CFR 337.6, their inherent risk characteristics may be similar to those of brokered deposits. That is, such deposits are typically attractive to rate-sensitive customers who may not have significant loyalty to the bank. Extensive reliance on funding products of this type, especially those obtained from outside a bank’s geographic market area, has the potential to weaken a bank’s funding position in times of stress.

Under the 2001 joint agency advisory, banks are expected to perform adequate due diligence before entering any business relationship with a deposit broker; assess the potential risks to earnings and capital associated with brokered deposits; and fully incorporate the assessment and control of brokered deposits into all elements of their liquidity-risk management processes, including CFPs.

*Public or government deposits.* Public funds generally represent deposits of the U.S. government, state governments, and local political subdivisions; they typically require collateral to be pledged against them in the form of securities. In most banks, deposits from the U.S. government represent a much smaller portion of total public funds than that of funds obtained from states and local political subdivisions. Liquidity-risk managers generally consider the secured nature of these deposits as being a double-edged sword. On the one hand, they reduce contingent liquidity risk because secured funds providers are less credit-sensitive, and therefore their deposits may be more stable than those of unsecured funds providers. On the other hand, such deposits reduce standby liquidity by “consuming” the potential liquidity in the pledged collateral.

Rather than pledge assets as collateral for public deposits, banks may also purchase an insurance company’s surety bond as coverage for public funds in excess of FDIC insurance limits. Here, the bank would not pledge assets to secure deposits, and the purchase of surety bonds would not affect the availability of funds to all depositors in the event of insolvency. The costs associated with the purchase of a surety bond must be taken into consideration when using this alternative.

Deposits from taxing authorities (most school districts and municipalities) also tend to be highly seasonal. The volume of public funds

8. Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision. May 11, 2001. See SR-01-14.

risers around tax due dates and falls near the end of the period before the next tax due date. This fluctuation is clearly a consideration for liquidity managers projecting cash flows for normal operations. State and local governments tend to be very rate-sensitive. Effective liquidity managers fully consider the contingent liquidity risk these deposits entail, that is, the risk that the deposits will not be maintained, renewed, or replaced unless the bank is willing to offer very competitive rates.

*Eurodollar deposits.* Eurodollar time deposits are certificates of deposit issued by banks outside of the United States. Large, internationally active U.S. banks may obtain Eurodollar funding through their foreign branches—including offshore branches in the Cayman Islands or other similar locales. Eurodollar deposits are usually negotiable CDs issued in amounts of \$100,000 or more, with rates tied to LIBOR. Because they are negotiable, the considerations applicable to negotiable CDs set forth above also apply to Eurodollar deposits.

*Federal funds purchased.* Federal funds (fed funds) are excess reserves held at Federal Reserve Banks. The most common type of federal funds transaction is an overnight, unsecured loan. Transactions that are for a period longer than one day are called *term fed funds*. The day-to-day use of fed funds is a common occurrence, and fed funds are considered an important money market instrument used in managing daily liquidity needs and sources.

Many regional and money-center banks, acting in the capacity of correspondents to smaller community banks, function as both providers and purchasers of federal funds. Overnight fed funds purchased can pose a contingent liquidity risk, particularly if a bank is unable to roll over or replace the maturing borrowing under stress conditions. Term fed funds pose almost the same risk since the term is usually just a week or two. Fed funds purchased should generally be treated as a volatile source of funds.

*Loans from correspondent banks.* Small and medium-sized banks often negotiate loans from their principal correspondent banks. The loans are usually for short periods and may be secured or unsecured. Correspondent banks are usually moderately credit-sensitive. Accordingly, cash-flow projections for normal business conditions and mild adverse scenarios may often treat these

funds as stable. However, given the credit sensitivity of such funds, projections computed for severe adverse liquidity scenarios should treat these funds as volatile.

*FHLB borrowings.* The Federal Home Loan Banks (FHLBs) provide loans, referred to as *advances*, to members. Advances must be secured by collateral acceptable to the FHLB, such as residential mortgage loans and mortgage-backed securities. Both short-term and long-term FHLB borrowings, with maturities ranging from overnight to 10 years, are available to member institutions at generally competitive interest rates. For some small and medium-sized banks, long-term FHLB advances may be a significant or the only source of long-term funding.

It should be noted that FHLBs may also sell their excess cash into the market in the form of fed funds. This is a transaction where the FHLB is managing its excess funding and has chosen to invest that excess in short-term unsecured fed funds. This transaction is executed through the capital markets and is not done with specific members of the FHLB.

Some FHLB advances contain embedded options or other features that may increase funding risk. For example, some types of advances, such as puttable and convertible advances, provide the FHLB with the option to either recall the advance or change the interest rate on an advance from a fixed rate to a floating rate under specified conditions. When such optionality exists, institutions should fully assess the implications of this optionality on the liquidity-risk profile of the institution.

In general, an FHLB establishes a line of credit for each of its members. Members are required to purchase FHLB stock before a line of credit is established, and the FHLB has the ability to restrict the redemption of its stock. An FHLB may also limit or deny a member's request for an advance if the member engages in any unsafe or unsound practice, is inadequately capitalized, sustains operating losses, is deficient with respect to financial or managerial resources, or is otherwise deficient.

Because FHLB advances are secured by collateral, the unused FHLB borrowing capacity of a bank is a function of both its eligible, unpledged collateral and its unused line of credit with its FHLB.

FHLBs have access to bank regulatory information not available to other lenders. The com-

posite rating of an institution is a factor in the approval for obtaining an FHLB advance, as well as the level of collateral required and the continuance of line availability. Because of this access to regulatory data, an FHLB can react quickly to reduce its exposure to a troubled institution by exercising options or not rolling over unsecured lines of credit. Depending on the severity of a troubled institution's condition, an FHLB has the right to increase collateral requirements or to discontinue or withdraw (at maturity) its collateralized funding program because of concerns about the quality or reliability of the collateral or other credit-related concerns. On the one hand, this right may create liquidity problems for an institution, especially if it has large amounts of short-term FHLB funding. At the same time, because FHLB advances are fully collateralized, the various FHLBs have historically worked with regulators prior to exercising their option to fully withdraw funding from members. To this extent, FHLB borrowings are viewed by many liquidity managers as a relatively stable source of funding, barring the most severe of adverse funding situations.

Sound liquidity-risk management practices call for institutions to fully document the purpose of any FHLB-borrowing transaction. Each transaction should be analyzed on an ongoing basis to determine whether the arrangement achieves the stated purpose or whether the borrowings are a sign of liquidity deficiencies. Some banks may use their FHLB line of credit to secure public funds; however, doing so will reduce their available funds and may present problems if the FHLB reduces the institution's credit line. Additionally, the institution should periodically review its borrowing agreement with the FHLB to determine the assets collateralizing the borrowings and the potential risks presented by the agreement. In some instances, the borrowing agreement may provide for collateralization by all assets not already pledged for other purposes.

*Repurchase agreements and dollar rolls.* The terms *repurchase agreement*<sup>9</sup> (repo) and *reverse repurchase agreement* refer to transactions in which a bank acquires funds by selling securities and simultaneously agreeing to repurchase the securities after a specified time at a given price, which typically includes interest at an agreed-on rate. A transaction is considered a

repo when viewed from the perspective of the supplier of the securities (the borrower) and a reverse repo or matched sale–purchase agreement when described from the point of view of the supplier of funds (the lender).

A repo commonly has a near-term maturity (overnight or a few days) with tenors rarely exceeding three months. Repos are also usually arranged in large dollar amounts. Repos may be used to temporarily finance the purchase of securities and dealer securities inventories. Banking organizations also use repos as a substitute for direct borrowings. Bank securities holdings as well as loans are often sold under repurchase agreements to generate temporary working funds. These types of agreements are often used because the rate on this type of borrowing is less than the rate on unsecured borrowings, such as federal funds purchased.

U.S. government and agency securities are the most common type of instruments sold under repurchase agreements, since they are exempt from reserve requirements. However, market participants sometimes alter various contract provisions to accommodate specific investment needs or to provide flexibility in the designation of collateral. For example, some repo contracts allow substitutions of the securities subject to the repurchase commitment. These transactions are often referred to as *dollar repurchase agreements* (dollar rolls), and the initial seller's obligation is to repurchase securities that are substantially similar, but not identical, to the securities originally sold. To qualify as a financing, these agreements require the return of "substantially similar securities" and cannot exceed 12 months from the initiation of the transaction. The dollar-roll market primarily consists of agreements that involve mortgage-backed securities.

Another common repo arrangement is called an *open repo*, which provides a flexible term to maturity. An open repo is a term agreement between a dealer and a major customer in which the customer buys securities from the dealer and may sell some of them back before the final maturity date.

Effective liquidity-risk managers ensure that they are aware of special considerations and potential risks of repurchase agreements, especially when the bank enters into large-dollar-volume transactions with institutional investors or brokers. It is a fairly common practice to adjust the collateral value of the underlying

9. See section 3010.1.

securities daily to reflect changes in market prices and to maintain the agreed-on margin. Accordingly, if the market value of the repo-ed securities declines appreciably, the borrower may be asked to provide additional collateral. Conversely, if the market value of the securities rises substantially, the lender may be required to return the excess collateral to the borrower. If the value of the underlying securities exceeds the price at which the repurchase agreement was sold, the bank could be exposed to the risk of loss if the buyer is unable to perform and return the securities. This risk would increase if the securities were physically transferred to the institution or broker with which the bank has entered into the repurchase agreement.

Because these instruments are usually very short-term transactions, institutions using them incur contingent liquidity risk. Accordingly, cash-flow projections for normal and mild scenarios usually treat these funds as stable. However, projections computed for severe scenarios generally treat these funds as volatile.

*International borrowings.* International borrowings may be direct or indirect. Common forms of direct international borrowings include loans and short-term call money from foreign banks, borrowings from the Export-Import Bank of the United States, and overdrawn nostro accounts (due from foreign bank demand accounts). Indirect forms of borrowing include notes and trade bills rediscounted with the central banks of various countries; notes, acceptances, import drafts, or trade bills sold with the bank's endorsement or guarantee; notes and other obligations sold subject to repurchase agreements; and acceptance pool participations. In general, these borrowings are often considered to be highly volatile, nonstable sources of funds.

*Federal Reserve Bank borrowings.* In 2003, the Federal Reserve Board revised Regulation A to provide for primary and secondary credit programs at the discount window.<sup>10</sup> (See section 4025.1.) Reserve Banks will extend primary credit at a rate above the target fed funds rate on a short-term basis (typically, overnight) to eligible depository institutions, and acceptable

collateral is required to secure all obligations. Discount window borrowings can be secured with an array of collateral, including consumer and commercial loans. Eligibility for primary credit is based largely on an institution's examination rating and capital status. In general, institutions with composite CAMELS ratings of 1, 2, or 3 that are at least adequately capitalized are eligible for primary credit unless supplementary information indicates their condition is not generally sound. Other conditions exist to determine eligibility for 4- and 5-rated institutions.

An institution eligible for primary credit need not exhaust other sources of funds before coming to the discount window. However, because of the above-market price of primary credit, the Reserve Banks expect institutions to mainly use the discount window as a backup source of liquidity rather than as a routine source. Generally, Reserve Banks extend primary credit on an overnight basis with minimal administrative requirements to eligible institutions. Reserve Banks may also extend primary credit to eligible institutions for periods of up to several weeks if funding is not available from other sources. These longer extensions of credit are subject to greater administrative oversight. Reserve Banks also offer secondary credit to institutions that do not qualify for primary credit. Secondary credit is another short-term backup source of liquidity, although its availability is more limited and is generally used for emergency backup purposes. Reserve Banks extend secondary credit to assist in an institution's timely return to a reliance on traditional funding sources or in the resolution of severe financial difficulties. This program entails a higher level of Reserve Bank administration and oversight than primary credit.

*Treasury Tax and Loan deposits.* Treasury Tax and Loan accounts (TT&L accounts) are maintained at banks by the U.S. Treasury to facilitate payments of federal withholding taxes. Banks may select either the "remittance-option" or the "note-option" method of forwarding deposited funds to the U.S. Treasury. In the remittance option, the bank remits the TT&L account deposits to the Federal Reserve Bank the next business day after deposit, and the remittance portion is not interest-bearing. The note option permits the bank to retain the TT&L deposits. In the note option, the bank debits the TT&L remittance account for the amount of the previous day's deposit and simultaneously credits the

10. See the "Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management," Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, July 25, 2003, and SR-03-15. See also section 3010.1.



note-option account. Note-option accounts are interest-bearing and can grow to a substantial size.

TT&L funds are considered purchased funds, evidenced by an interest-bearing, variable-rate, open-ended, secured note callable on demand by Treasury. As per 31 CFR 203.24, the TT&L balance requires pledged collateral, usually from the bank's investment portfolio. Because they are secured, TT&L balances reduce standby liquidity from investments, and because they are callable, TT&L balances are considered to be volatile and they must be carefully monitored. However, in most banks, TT&L deposits constitute only a minor portion of total liabilities.

### C. Off-Balance-Sheet Obligations

Off-balance-sheet transactions have been one of the fastest-growing areas of banking activity. While these activities may not be reflected on the balance sheet, they must be thoroughly reviewed in assessing an institution's liquidity-risk profile, as they can expose the institution to significant contingent liquidity risk. Effective liquidity-risk managers pay particular attention to potential liquidity risks in loan commitments, lines of credit, performance guarantees, and financial guarantees. Banks should estimate both the amount and the timing of potential cash flows from off-balance-sheet claims.

Effective liquidity managers ensure that they consider the correlation of draws on various types of commitments that can trend with macroeconomic conditions. For example, standby letters of credit issued in lieu of construction completion bonds are often drawn when builders cannot fulfill their contracts. Some types of credit lines, such as those used to provide working capital to businesses, are most heavily used when either the borrower's accounts receivable or inventory is accumulating faster than its collections of accounts payable or sales. Liquidity-risk managers should work with the appropriate lending managers to track such trends.

In addition, funding requirements arising from some types of commitments can be highly correlated with the counterparty's credit quality. Financial standby letters of credit (SBLOCs) are often used to back the counterparty's direct financial obligations, such as commercial paper, tax-exempt securities, or the margin require-

ments of securities and derivatives exchanges. At some institutions, a major portion of off-balance-sheet claims consists of SBLOCs supporting commercial paper. If the institution's customer issues commercial paper supported by an SBLOC and if the customer is unable to repay the commercial paper at maturity, the holder of the commercial paper will request that the institution perform under the SBLOC. Liquidity-risk managers should work with the appropriate lending manager to (1) monitor the credit grade or default probability of such counterparties and (2) manage the industry diversification of these commitments in order to reduce the probability that multiple counterparties will be forced to draw against the bank's commitments at the same time.

Funding under some types of commitments can also be highly correlated with changes in the institution's own financial condition or perceived credit quality. Commitments supporting various types of asset-backed securities, asset-backed commercial paper, and derivatives can be subject to such contingent liquidity risk. The securitization of assets generally requires some form of credit enhancement, which can take many forms, including SBLOCs or other types of guarantees issued by a bank. Similarly, many structures employ *special-purpose entities* (SPEs) that own the collateral securing the asset-backed paper. Bank SBLOCs or guarantees often support those SPEs. As long as the institution's credit quality remains above defined minimums, which are usually based on ratings from NRSROs, few or none of the SBLOCs will fund. However, if the institution's credit rating falls below the minimum, a significant amount or all of such commitments may fund at the same time.

Financial derivatives can also give rise to contingent liquidity risk arising from financial market disruptions and deteriorating credit quality of the banking organization. Derivatives contracts should be reviewed, and their potential for early termination should be assessed and quantified, to determine the adequacy of the institution's available liquidity. Many forms of standardized derivatives contracts allow counterparties to request collateral or to terminate contracts early if the institution experiences an adverse credit event or deterioration in its financial condition. In addition, under situations of market stress, a customer may ask for early termination of some contracts. In such circumstances, an institution that owes money

on derivatives transactions may be required to deliver collateral or settle a contract early, when the institution is encountering additional funding and liquidity pressures. Early terminations may also create additional, unintended market exposures. Management and directors should be aware of these potential liquidity risks and address them in the institution's CFP. All off-balance-sheet commitments and obligations should receive the focused attention of liquidity-risk managers throughout the liquidity-risk management process.

#### *D. Specialized Business Activities*

Institutions that engage in specialized banking activities should ensure that all elements of these activities are fully incorporated into their assessment of liquidity-risk exposure and their ongoing management of the firm's liquidity. Such activities may include mortgage servicing, trading and dealer activities, and various types of fee-income-generating businesses.

Institutions engaged in significant payment, clearing, and settlement activities face particular challenges. Institutions that are active in payment, settlement, or clearing activities should ensure that they have mechanisms for measuring, monitoring, and identifying the amount of liquidity they may need to settle obligations in normal as well as stressed environments. These institutions should fully consider the unique risks that may result from their participation in different payment-system activities and factor these risks into their liquidity contingency planning. Factors that banks should consider when developing liquidity plans related to payment activities include—

- the impact of pay-in rules of individual payment systems, which may result in short-notice payment adjustments and the need to assess peak pay-in requirements that could result from the failure of another participant;
- the potential impact of operational disruptions at a payment utility and the potential need to move activity to another venue in which settlement is gross rather than net, thereby increasing liquidity requirements to settle;
- the impact that the deteriorating credit quality of the institution may have on collateral requirements, changes in intraday lending limits, and the institution's intraday funding needs; and
- for clearing and nostro service providers, the

impact of potential funding needs that could be generated by their clearing customers in addition to the bank's own needs.

#### **IV. Summary Measures of Liquidity-Risk Exposure**

Cash-flow projections constructed assuming normal and adverse conditions provide a wealth of information about the liquidity profile of an institution. However, liquidity managers, bank supervisors, rating agencies, and other interested parties use a myriad of summary measures of liquidity to identify potential liquidity risk. These measures include various types of financial ratios. Many of these measures attempt to achieve some of the same insights provided by comprehensive cash-flow scenario analyses but use significantly less data. When calculated using standard definitions and comparable data, such measures provide the ability to track trends over time and facilitate comparisons across peers. At the same time, however, many summary measures necessarily entail simplifying assumptions regarding the liquidity of assets, the relative stability or volatility of liabilities, and the ability of the institution to meet potential funding needs. Supervisors, management, and other stakeholders that use these summary measures should fully understand the effect of these assumptions and the limitations associated with summary measures.

Although general industry conventions may be used to compute various summary measures, liquidity managers should ensure that the specific measures they use for internal purposes are suitably customized for their particular institution. Importantly, effective liquidity managers recognize that no single summary measure or ratio captures all of the available sources and uses of liquidity for all situations and for all time periods. Different ratios capture different facets of liquidity and liquidity risk. Moreover, the same summary measure or ratio calculated using different assumptions can also capture different facets of liquidity. This is an especially important point since, by definition, many liquidity ratios are scenario-specific. Measures constructed using normal-course-of-business assumptions can portray liquidity profiles that are significantly different from those constructed assuming stress contingency events. Indeed,

many liquidity managers use the same summary measures and financial ratios computed under alternative scenarios and assumptions to evaluate and communicate to senior management and the board of directors the institution's liquidity-risk profile and the adequacy of its CFPs.

### A. Cash-Flow Ratios

Cash-flow ratios are especially valuable summary liquidity measures. These measures summarize the information contained in detailed cash-flow projections and forecasts. They are generally constructed as the ratio of total projected cash inflows divided by total projected cash outflows for a particular time period or cash-flow-projection time bucket. The ratio for a given time bucket indicates the relative amount by which the projected sources of liquidity cover projected needs. For example, a ratio of 1.20 indicates a liquidity "surplus" equal to 20 percent of projected outflows. In general, such coverage ratios are compiled for each time bucket in the cash-flow projections used to assess both normal and adverse liquidity circumstances.

Some institutions also employ cumulative cash-flow ratios that are computed as the ratio of the cumulative sum of cash inflows to the cumulative sum of cash outflows for all time buckets up to a given time bucket. However, care should be taken to recognize that cumulative cash-flow ratios used alone and without the benefit of assessing the individual time-period exposures for each of their component time buckets may mask liquidity-risk exposures that can exist at intervals up to the cumulative time horizons chosen.

### B. Other Summary Liquidity Measures

Other common summary liquidity measures employ assumptions about, and depend heavily on, the assessment and characterization of the relative marketability and liquidity of assets and the relative stability or volatility of funding needs and sources, consistent with the considerations discussed in the prior section. Liquidity managers use these other measures to review historical trends, summarize their projections of potential liquidity-risk exposures under adverse liquidity conditions, and develop strategies to address contingent liquidity events. In selecting

from the myriad of available measures, effective liquidity managers focus primarily on those measures that are most related to the liquidity-management strategies pursued by the institution. For example, institutions that focus on managing asset liquidity place greater emphasis on measures that gauge such conditions, while institutions placing greater emphasis on managing liability liquidity emphasize measures that address those aspects of their liquidity-risk profile.

The following discussions briefly describe some of the more common summary measures of liquidity and liquidity risk. Some of these measures are employed by liquidity managers, rating agencies, and supervisors using definitions and calculation methods amenable to publicly available Call Report or BHC Performance Report data. Because such data require the use of assumptions on the liquidity of broad classes of assets and on the stability of various types of aggregated liabilities, liquidity managers and supervisors should take full advantage of the available granularity of internal data to customize the summary measures they are using. Incorporating internal data ensures that summary measures fit the specific liquidity profile of the institution. Such customization permits a more robust assessment of the institution's liquidity-risk profile.

In general, most common summary measures of liquidity and liquidity risk can be grouped into the following three broad categories:

1. those that portray the array of assets along a continuum of liquidity and cash-flow characteristics for normal and potentially adverse circumstances
2. those that portray the array of liabilities along a continuum of potential volatility and stability characteristics under normal and potentially adverse circumstances
3. those that assess the balance between funding needs and sources based on assumptions about both the relative liquidity of assets and the relative stability of liabilities

*Relative liquidity of assets.* Summary measures that address the liquidity of assets usually start with assessments of the maturity or type of assets in an effort to gauge their contributions to actual cash inflows over various time horizons. In general, they represent an attempt to summarize and characterize the expected cash inflows from assets that are estimated in more-detailed

cash-flow-projection worksheets assuming normal business conditions. Summary measures assessing the liquidity of assets include such measures as—

- short-term investments (defined as maturing within a specified time period, such as 3 months, 6 months, or 1 year) as a percent of total investments, and
- short-term assets (defined as maturing within a specified time period) as a percent of total assets.

Other measures within this category attempt to assess the expected time period over which longer-term, illiquid assets may need to be funded. These measures, which use broad asset categories and employ strong assumptions on the liquidity of these assets, include—

- loans and leases as a percent of total assets, and
- long-term assets (defined as maturing beyond a specified time period) as a percent of total assets.

To better gauge the potential for assets to be used as sources of liquidity to meet uncertain future cash needs, effective liquidity managers use additional “liquid asset” summary measures that are customized to take into account the ability (or inability) to convert assets into cash or borrowed funds. Such measures attempt to summarize the potential for sale, securitization, or use as collateral of different types of assets, subject to appropriate scenario-specific haircuts. Such measures also attempt to recognize the constraints on potential securitization and on those assets that have already been pledged as collateral for existing borrowings. Examples of these measures include—

- marketable securities (as determined by the assessment of cash-flow, accounting, and haircut considerations discussed in the previous section) to total securities;
- marketable securities as a percent of total assets;
- marketable assets (as determined by the assessment of cash-flow, accounting, and haircut considerations discussed in the previous section) to total assets;
- pledgable assets (e.g., unpledged securities and loans) as a percent of total assets;
- pledged securities (or pledged assets) to total

- pledgable securities (or pledgable assets);
- securitizable assets to total assets (sometimes computed to include some assessment of the time frame that may be involved); and
- liquid assets to total assets with the measure of liquid assets being some combination of short-term assets, marketable securities, and securitizable and pledgable assets (ensuring that any pledged assets are not double-counted).

*Relative stability or volatility of liabilities as a source of funding.* Summary measures used to assess the relative stability or volatility of liabilities as sources of funding often start with assessments of the maturity of liabilities and their ability to be “rolled-over” or renewed under both normal business and potentially adverse circumstances. These measures also represent an attempt to summarize and characterize the use of actual and potential sources of funds, which are estimated in more-detailed cash-flow-projection worksheets. In fact, proper construction of many of these summary measures requires the same analytical assessments required for cash-flow projections. Such measures attempt to gauge and array the relative sensitivity and availability of different sources of funds on the basis of the anticipated behavior of various types of transactions, business activities, funds providers, or other attributes.

Given the difficulties involved in portraying funding sources across the entire continuum of stability and volatility characteristics, along with the complexity of overlaying alternative contingent scenarios on such portrayals, some common summary measures attempt to group funding sources as falling on one side or the other of this continuum. Financial ratios that attempt to portray the extent to which an institution’s funding sources are stable include—

- total deposits as a percent of total liabilities or total assets;
- insured deposits as a percent of total deposits;
- deposits with indeterminate maturities as a percent of total deposits; and
- long-term liabilities (defined as maturing beyond a specified time period) to total liabilities.

These measures necessarily employ assumptions about the stability of an institution’s deposit base in an attempt to define a set of relatively stable or core funding sources. Liquidity man-

agers and examiners should take care in constructing their estimates of stable or core liabilities for use in such measures. This caution has become especially important as changes in customer sophistication and interest-rate sensitivity have altered behavioral patterns and, therefore, the stability characteristics traditionally assumed for retail and other types of deposits traditionally termed “core.” As a result, examiners, liquidity managers, and other parties should use more-granular breakouts of funding sources to assess the relative stability of deposits and should not place undue reliance on standardized traditional measures of core deposits. Breakouts that use such a greater granularity include—

- various breakouts of retail deposits to total deposits based on product type (MMDA, demand deposit, savings account, etc.) and customer segmentation to total deposits or liabilities;
- breakouts of various types of institutional deposits (e.g., collateralized deposits of municipal and government entities) as a percent of deposits; and
- various breakouts of brokered deposits (by size, types of fund providers, and maturity).

At the other end of the stability/volatility continuum, some summary measures focus on identifying those sources of funding that need to be rolled over in the short term under normal business conditions and those whose rollover or usage in the future may be especially sensitive to institution-specific contingent liquidity events. These measures include—

- short-term liabilities (defined as fund sources maturing within a specified time period, such as 3 months, 6 months, or 1 year) as a percent of total liabilities;
- short-term brokered deposits as a percent of total deposits;
- insured short-term brokered deposits as a percent of total deposits;
- purchased funds (including short-term liabilities such as fed funds purchased, repos, FHLB borrowings, and other funds raised in secondary markets) as a percent of total liabilities;
- uncollateralized purchased funds as a percent of total liabilities; and
- short-term purchased funds to total purchased funds.

When computing measures to assess the availability of potential sources of funds under contingent liquidity scenarios, institutions may adjust the carrying values of their liabilities in order to develop best estimates of available funding sources. Similar to the haircuts applied when assessing marketable securities and liquid assets, such adjustments endeavor to identify more-realistic rollover rates on current and potential funding sources.

*Balance between funding needs and sources.*

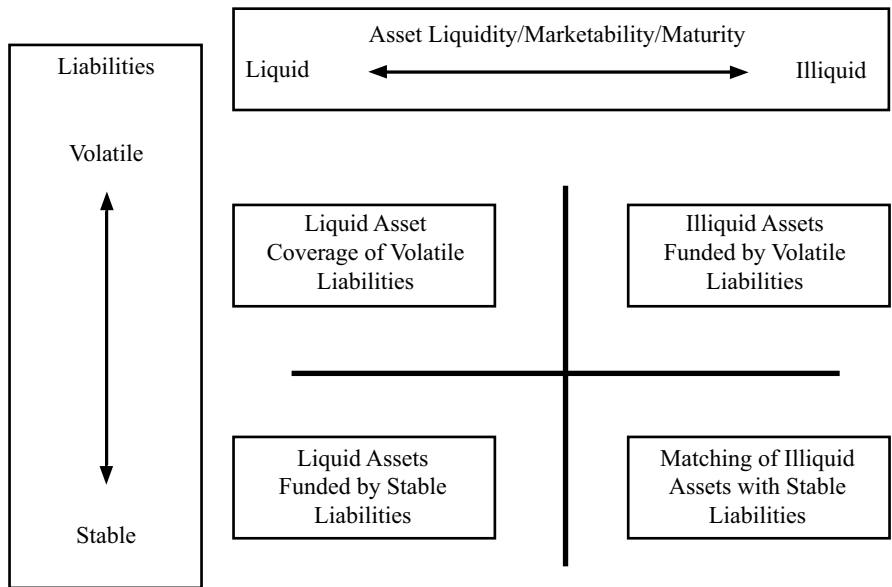
Measures used to assess the relationship between actual or potential funding needs and funding sources are constructed across a continuum that arrays both the tenor or relative liquidity of assets and the potential volatility or stability of liabilities. Many of these measures use concepts discussed earlier regarding the liquidity of assets and the relative stability or volatility of liabilities as funding sources. Some measures express various definitions of short-term liquid assets to total liabilities or alternative definitions of volatile or stable liabilities to total assets. Such measures may include—

- net short-term liabilities (short-term liabilities minus short-term assets) as a percent of total assets;
- stable deposits as a percent of total assets;
- total purchased funds as a percent of total assets;
- uncollateralized borrowings as a percent of total assets; and
- liquid assets as a percent of total liabilities.

Other measures attempt to identify the relationships between different classifications of liquid or illiquid assets and stable or volatile liabilities. Exhibit 6 provides a conceptual schematic of the range of relationships that are often addressed in such assessments.

Some commonly used summary liquidity measures and ratios focus on the amount of different types of liquid assets that are funded by various types of short-term and potentially volatile liabilities (upper-left quadrant of exhibit 6). One of the most common measures of this type is the “net short-term position” (used by some NRSROs). Liquidity managers, bank supervisors, and rating agencies use this measure to assess an institution’s ability to meet its potential cash obligations over a specified period of time. It is computed as an institution’s liquid assets (incorporating appropriate haircuts on

## Exhibit 6—Relationships Between Liquid or Illiquid Assets and Stable or Volatile Liabilities



marketable assets) minus the potential cash obligations expected over the specified time period (e.g., 3 months, 6 months, or 1 year). Other measures used to assess the relationship or coverage of potentially volatile liabilities by liquid assets include—

- short-term investments (defined as investments maturing within a specified time period, such as 3 months, 6 months, or 1 year) as a percent of short-term and potentially volatile liabilities; and
- short-term investments (defined as investments maturing within a specified time period, such as 3 months, 6 months, or 1 year) as a percent of short-term liabilities (defined as liabilities maturing within a specified time period, such as 3 months, 6 months, or 1 year).

Other summary liquidity measures take a more expansive approach to assessing the continuum of liquid assets and volatile liabilities by including more items or expanding the breadth of analysis. Such measures include—

- liquid assets (defined as a combination of short-term assets, marketable securities, and securitizable and pledgable assets—ensuring that any pledged assets are not double-counted—over a certain specified time frame) as a percent of liabilities judged to be volatile (over the same time period);
- liquidity-surplus measures, such as liquid assets minus short-dated or volatile liabilities; and
- liquid assets as a percent of purchased funds.

Other common summary measures of liquidity focus on the potential mismatch of using short-term or potentially volatile liabilities to fund illiquid assets (upper-right-hand quadrant of exhibit 6). Often these measures factor only those volatile liabilities in excess of short-term and highly liquid assets or marketable investment securities into this assessment. Such volatile-liability-dependence measures provide insights as to the extent to which alternative funding sources might be needed to fund long-term liquidity needs under adverse liquidity conditions. These measures include—

- net short-term noncore-funding-dependence measures, such as short-term volatile funding minus short-term investments as a percent of illiquid assets; and
- net volatile-funding-dependence measures, such as volatile funding minus liquid assets as a percent of illiquid assets.

Another set of summary liquidity ratios can be constructed to focus on the extent to which illiquid assets are match-funded by stable liabilities (lower-right quadrant of exhibit 6). Common examples of such measures include traditional loan-to-deposit ratios (which incorrectly assume all deposits are stable) and loan-to-core-deposit ratios (which often take a product-specific approach to defining the stability of certain types of deposits). However, since such traditional measures necessarily require the use of broad assumptions on the stability of deposits, they should not be relied on to provide meaningful insights regarding potential funding mismatches between stable funding sources and illiquid assets.

One meaningful measure used to gauge such relationships is the concept of “net cash capital” (which is also used by some NRSROs). This measure is the dollar amount by which stable sources of funds exceed illiquid assets; it can be computed as a percent of total assets to facilitate comparisons across institutions. In addition, it can be computed using customized assessments of the relative stability of different types of liabilities and the ability to convert assets into cash through sale, securitization, or collateralization. For example, firms may choose to exclude portions of loans sold regularly (e.g., loans conforming to secondary-market standards) as illiquid assets, or they may choose to include long-term debt as stable liabilities.

A final set of summary measures are used by liquidity managers to optimize the liquidity profiles of their institutions. These measures assess the extent to which relatively stable funding sources are used to fund short-term and liquid assets (lower-left quadrant of exhibit 6). Since short-term liquid assets generally entail relatively lower returns than longer-term less-liquid assets, measures assessing such potential mismatches focus liquidity managers on the cost of carrying liquid assets.

## V. Liquidity-Measurement Considerations for Bank Holding Companies

Liquidity-risk measurement considerations for BHCs can be found in the *Bank Holding Company Supervision Manual*, sections 4000.1, 4010, and 4020.

### APPENDIX 2—SUMMARY OF MAJOR LEGAL AND REGULATORY CONSIDERATIONS

The following discussions summarize some of the major legal and regulatory considerations that should be taken into account in managing the liquidity risk of banking organizations. The discussions are presented only to highlight potential issues and to direct bankers and supervisors to source documents on those issues.

#### A. Federal Reserve Regulation A

Federal Reserve Regulation A addresses borrowing from the discount window. Rules defining eligible collateral can be found in this regulation.

#### B. Federal Reserve Regulation D

Federal Reserve Regulation D addresses required reserves for deposits. One portion of the regulation, however, restricts the type of eligible collateral that can be pledged for repurchase-agreement borrowings.

#### C. Federal Reserve Regulation F

Federal Reserve Regulation F imposes limits on interbank liabilities. This regulation implements section 308 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA). Banks that sell funds to other banks must have written policies to limit excessive exposure, must review the financial condition or credit rating of the debtor, must have internal limits on the size of exposures that are consistent with the credit risk, may not lend more than 25 percent of their

capital to a single borrowing bank, and must undertake other steps.

Banks that borrow federal funds or other borrowings from correspondent banks may find, as a result of the seller's compliance with Regulation F, that the amount they may borrow has suddenly declined as a result of a reduction in their credit rating or credit quality. Regulation F may make it harder for a bank to use borrowings as a liquidity source for a bank-specific liquidity crisis.

## D. Federal Reserve Regulation W

Federal Reserve Regulation W governs transactions between an insured bank or thrift and its affiliates. The regulation establishes a consistent and comprehensive compilation of requirements found in section 23A of the Federal Reserve Act, 70 years of Board interpretations of section 23A, section 23B of the Federal Reserve Act, and portions of the Gramm-Leach-Bliley Act of 1999. Covered transactions include purchases of assets from an affiliate, extensions of credit to an affiliate, investments in securities issued by an affiliate, guarantees on behalf of an affiliate, and certain other transactions that expose the member bank to an affiliate's credit or investment risk. Derivatives transactions and intraday extensions of credit are also covered.

The intentions of the regulation are (1) to protect the depository institution, (2) to ensure that all transactions between the bank and its affiliates are on terms and conditions that are consistent with safe and sound banking practices, and (3) to limit the ability of a depository institution to transfer to its affiliates the subsidy arising from the institution's access to the federal safety net. The regulation achieves these goals in four major ways:

1. It limits a member bank's covered transactions with any single affiliate to no more than 10 percent of the bank's capital stock and surplus, and limits transactions with all affiliates combined to no more than 20 percent of the bank's capital stock and surplus.
2. It requires all transactions between a member bank and its affiliates to be on terms and conditions that are consistent with safe and sound banking practices.
3. It prohibits a member bank from purchasing low-quality assets from its affiliates.

4. It requires that a member bank's extensions of credit to affiliates and guarantees on behalf of affiliates be appropriately secured by a statutorily defined amount of collateral.

Section 23B protects member banks by requiring that certain transactions between the bank and its affiliates occur on market terms, that is, on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with unaffiliated companies. Section 23B applies the market-terms restriction to any covered transaction (as defined in section 23A) with an affiliate as well as certain other transactions, such as (1) any sale of assets by the member bank to an affiliate, (2) any payment of money or furnishing of services by the member bank to an affiliate, and (3) any transaction by the member bank with a third party if an affiliate has a financial interest in the third party or if an affiliate is a participant in the transaction.

Liquidity-risk managers working in banks that have affiliates must give careful attention to Regulation W, which addresses transactions between banks and their affiliates. In the normal course of business, the prohibition on unsecured funding can tie up collateral, complicate collateral management, and restrict the availability of funding from affiliates. In stressed conditions, all of those problems—plus the size limit and the prohibition on sales of low-quality assets to affiliates—effectively close down many transactions with affiliates.

## E. Statutory Restriction of FHLB Advances

The Federal Home Loan Banks (FHLBs) provide a number of different advance programs with very attractive terms to member banks. Many banks now use the FHLBs for term funding. The FHLBs are very credit-sensitive lenders.

A federal regulation (12 CFR 935, Federal Housing Finance Board—Advances) requires the FHLBs to be credit-sensitive. In addition to monitoring the general financial condition of commercial banks and using rating information provided by bank rating agencies, the FHLBs have access to nonpublic regulatory information and supervisory actions taken



against banks. The FHLBs often react quickly, sometimes before other funds providers, to reduce exposure to a troubled bank by not rolling over unsecured borrowing lines. Depending on the severity of a troubled bank's condition, even the collateralized funding program may be discontinued or withdrawn at maturity because of concerns about the quality or reliability of the collateral or other credit-related concerns. Contractual provisions requiring increases in collateral may also be invoked. Any of these changes in FHLB-loan availability or terms can create significant liquidity problems, especially in banks that use large amounts of short-term FHLB funding.

### F. Statutory Restriction on the Use of Brokered Deposits

The use of brokered deposits is restricted by 12 CFR 337.6. Well-capitalized banks may accept brokered deposits without restriction. Adequately capitalized banks must obtain a waiver from the FDIC to solicit, renew, or roll over brokered deposits. Adequately capitalized banks must also comply with restrictions on the rates that they pay for these deposits. Banks that have capital levels below adequately capitalized are prohibited from using brokered deposits. In addition to these restrictions, banking regulators have also issued detailed guidance, discussed in section H below, on the use of brokered deposits.

### G. Legal Restrictions on Dividends

A number of statutory restrictions limit the amount of dividends that a bank may pay to its

stockholders. As a result, a bank holding company that depends on cash from its bank subsidiaries can find this source of funds limited or closed. This risk is particularly significant for bank holding companies with nonbank subsidiaries that require funding or debt service.

### H. Restrictions on Investments That Affect Liquidity-Risk Management

Interagency guidance issued in 1998 by the FFIEC, "Supervisory Policy Statement on Investment Securities and End-User Activities," contains provisions that may affect liquidity and liquidity management. (See SR-98-12.) The following points summarize some of these potential impacts, although readers should review the entire rule for more-complete information.

1. When banks specify permissible instruments for accomplishing established objectives, they must take into account the liquidity of the market for those investments and the effect that liquidity may have on achieving their objective.
2. Banks are required to consider the effects that market risk can have on the liquidity of different types of instruments under various scenarios.
3. Banks are required to clearly articulate the liquidity characteristics of the instruments they use to accomplish institutional objectives.

In addition, the policy statement specifically highlights the greater liquidity risk inherent in complex and less actively traded instruments.

# Liquidity Risk

## Examination Objectives

Effective date October 2010

## Section 4020.2

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1. To appropriately risk-focus the scope of the examination (that is, ensure that the scope is appropriate, given the institution's activities and the risks they present).
2. To assess the relative volatility or stability of the institution's liability funding sources.
3. To assess the institution's access to liquidity.
4. To assess the institution's potential liquidity needs.
5. To assess (1) the institution's exposure to mismatched risk under normal business conditions and (2) its planned strategies for addressing this risk.
6. To assess the institution's exposure to contingent liquidity risk.
7. To assess the appropriateness and integrity of the institution's corporate-governance policies for management of liquidity risk.
8. To determine whether the institution's policies, procedures, and limits are adequate, given its size, complexity, and sophistication.
9. To determine if management is adequately planning for intermediate-term and longer-term liquidity or funding needs.
10. To assess the adequacy of the institution's liquidity-risk measurement systems.
11. To assess the adequacy of the institution's liquidity-risk management information systems.
12. To assess the adequacy of the institution's contingency funding plans.
13. To assess the adequacy of the institution's internal controls for its liquidity-risk management process.
14. To determine whether the institution is complying with applicable laws and regulations.

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EXAMINATION SCOPE

1. Review the following documents to identify issues that may require follow-up:
  - a. prior examination findings and workpapers
  - b. audit reports, and
  - c. ongoing monitoring risk assessments (if available)
2. Review appropriate surveillance material, including the Uniform Bank Performance Report (UBPR), BHC Performance Report, and other reports, to identify liquidity trends and the liquidity-risk profile of the institution. This review should include assessments of the marketability of assets and the relative stability or volatility of funding sources.
3. Request and review internal reports management uses to monitor liquidity risk, including the following reports:
  - a. senior management, asset/liability committee (ALCO), and for the board of directors' meetings
  - b. cash-flow-projection reports
  - c. contingency funding plans (CFPs)
  - d. funding-concentration reports
4. Request and review organizational charts and liquidity-risk management policies and procedures.
5. Review the potential liquidity-risk exposure arising from the financial condition of the institution or other trends, such as asset growth, asset quality, earnings trends, capital adequacy, market-risk exposures (interest-rate risk (IRR) exposures for both the banking book and the trading book), business-line operational considerations, and the potential for legal and reputational risk.

On the basis of the hypothesis developed for both the institution's inherent liquidity-risk exposure and the adequacy of its liquidity management, select the steps necessary to meet examination objectives from the following procedures.

ASSESSMENT OF INHERENT LIQUIDITY RISK

1. Review the institution's deposit structure. Discuss the following issues with management: the institution's customer base, costs, and pricing strategies, as well as the stability of various types of deposits. This review should include—
  - a. assumptions about deposit behaviors the institution uses in making its cash-flow projections and in conducting its IRR analyses;
  - b. the competitiveness of rates paid on deposits, from both a national and local-market-area perspective;
  - c. lists of large depositors, potential deposit concentrations, and large deposit maturities;
  - d. the institution's use of brokered deposits and deposits from entities that may be especially sensitive to market rates and credit quality; and
  - e. public fund deposits, including pledging requirements and pricing policies.
2. Review the institution's use of nondeposit liabilities. Discuss with management its strategies for employing such funds, the sensitivity of such funds to market rates, and the credit quality of the institution. This review should include—
  - a. the types, costs, amounts, and concentrations of nondeposit liabilities used by the institution;
  - b. the strategies underlying the use of any Federal Home Loan Bank (FHLB) advances and the specific features of those borrowings, including the existence of any options, to determine if the institution adequately understands the risk profile of these borrowings;
  - c. the activities the institution funds with nondeposit liabilities;
  - d. the institution's use of short-term liabilities; and
  - e. compliance with the written agreements for borrowings.
3. Review the institution's holdings of marketable assets as liquidity reserves. This review should include—
  - a. the quality, maturity, marketability, and

- amount of unpledged investment securities;
- b. pledgable and securitizable loans and existing activities in this area; and
  - c. a discussion with management on its strategies for maintaining liquid asset reserves.
4. When applicable, review the institution's access to debt markets as a source of liquidity. This review should include—
    - a. the strength of current short- and longer-term debt ratings, including an assessment of the potential for “watch-listing” or downgrades;
    - b. the breadth of the investor base for the company's debt;
    - c. current and future issuance plans;
    - d. concentrations of borrowed funds;
    - e. the availability to utilize FHLB or other wholesale funds providers; and
    - f. the institution's reputation in the capital markets and with major funds providers.
  5. Review the institution's business activities that may have a significant impact on its liquidity needs. This review should include—
    - a. the institution's ability to securitize assets and the amount of its current and anticipated securitization activities;
    - b. payments- or securities-processing activities and other activities that may heighten the impact of operational risk on the liquidity of the firm;
    - c. the amount and nature of trading and over-the-counter (OTC) derivative activities that may have an impact on liquidity;
    - d. the extent of off-balance-sheet (OBS) loan commitments;
    - e. the balance-sheet composition, including significant concentrations that may have an impact on liquidity; and
    - f. operational risks associated with the institution's business activities, risks inherent in the corporate structure, or external factors that may have an impact on liquidity.
  6. Review the institution's cash-flow projections.
  7. Discuss with management the institution's strategies for dealing with seasonal, cyclical, and planned asset-growth funding strategies, including its assessment of alternative funding sources.
  8. Review and discuss with management the institution's identification of potential contingent liquidity events and the various levels of stress those events entail. Determine if the chosen scenarios are appropriate, given the institution's business activities and funding structure.
  9. Review cash-flow projections the institution has constructed for selected contingent liquidity events. Review the assumptions underlying the projections, including sources of funds to be used in a contingent liquidity event and the reports and assumptions on behavioral cash flows.
  10. Review the assumptions and trends in the institution's liquidity-risk “triggers.”
  11. Review CFPs.
  12. When appropriate, review reports on liquidity-risk triggers in the institution's securitization activities.
  13. On the basis of the above procedures, determine if the institution's inherent liquidity risk is low, limited, moderate, considerable, or high.

## ASSESSMENT OF THE QUALITY OF LIQUIDITY-RISK MANAGEMENT

1. Review formally adopted policies and procedures, as well as reports to the board of directors and senior management, to determine the adequacy of their oversight. This review should include whether the board and senior management—
  - a. have identified lines of authority and responsibility;
  - b. have articulated the institution's general liquidity strategies and its approach to liquidity risk;
  - c. understand the institution's liquidity CFPs; and
  - d. periodically review the institution's liquidity-risk profile.
2. Review senior management structures in order to determine their adequacy for overseeing and managing the institution's liquidity. This review should include—
  - a. whether the institution has designated an ALCO or other management decision-making body;
  - b. the frequency of ALCO meetings and the adequacy of the reports presented;
  - c. decisions made by the ALCO and validation of follow-up on those decisions,

- including ongoing assessment of open issues;
- d. the technical and managerial expertise of management and personnel involved in liquidity management; and
  - e. whether the institution has clearly delineated centralized and decentralized liquidity-management responsibilities.
3. Review and discuss with management the institution's liquidity-risk policies, procedures, and limits, and determine their appropriateness, comprehensiveness, and accuracy. Policies, procedures, and limits should—
- a. identify the objectives and strategies of the institution's liquidity management and its expected and preferred reliance on various sources of funds to meet liquidity needs under alternative scenarios;
  - b. delineate clear lines of responsibility and accountability over liquidity-risk management and management decision-making;
  - c. be consistent with institution practices;
  - d. identify the process for setting and reassessing limits, and communicate the rationale for the limit structure;
  - e. specify quantitative limits and guidelines that define the acceptable level of risk for the institution, such as the use of maximum and targeted amounts of cash-flow mismatches, liquidity reserves, volatile liabilities, and funding concentrations;
  - f. specify the frequency and methods used to measure, monitor, and control liquidity risk; and
  - g. define the specific procedures and approvals necessary for exceptions to policies, limits, and authorizations.
4. Review and discuss with management the bank's budget projections for the appropriate planning period. Ascertain if management has adequately—
- a. planned the future direction of the bank, noting the projected growth, the source of funding for the growth, and any projected changes in its asset or liability mix;
  - b. developed future plans for meeting ongoing liquidity needs; and
  - c. assessed the reasonableness of its plans to achieve (1) the amounts and types of funding projected and (2) the amounts and types of asset growth projected.
- Determine if management has identified alternative sources of funds if plans are not met.
5. Review the reasonableness of bank-established parameters for the use of volatile liabilities.
  6. Review liquidity-risk measurement policies, procedures, methodologies, models, assumptions, and other documentation. Discuss with management the—
    - a. adequacy and comprehensiveness of cash-flow projections and supporting analysis used to manage liquidity;
    - b. appropriateness of summary measures and ratios to adequately reflect the liquidity-risk profile of the institution;
    - c. appropriateness of the identification of stable and volatile sources of funding;
    - d. comprehensiveness of alternative contingent liquidity scenarios incorporated in the ongoing estimation of liquidity needs; and
    - e. the validity and appropriateness of assumptions used in constructing liquidity-risk measures.
  7. Review liquidity-risk management policies, procedures, and reports. Discuss with management the frequency and comprehensiveness of liquidity-risk reporting for the various levels of management that are responsible for monitoring and managing liquidity risk. These considerations should include the following:
    - a. management's need to receive reports that—
      - determine compliance with limits and controls;
      - evaluate the results of past strategies;
      - assess the potential risks and returns of proposed strategies;
      - identify the major changes in a bank's liquidity-risk profile; and
      - consolidate holding company and bank subsidiary information.
    - b. the need for the reporting system to be flexible enough to—
      - quickly collect and edit data, summarize results, and adapt to changing circumstances or issues without compromising data integrity; and
      - increase the frequency of report preparation as business conditions deteriorate.
    - c. the need for reports to properly focus on monitoring liquidity and supporting

- decisionmaking. These reports often help bank management to monitor—
- sources and uses of cash flows (i.e., cash flows from operating, investing, and financing activities), facilitating the evaluation of trends and structural balance-sheet changes;
  - CFPs;
  - projected cash-flow or maturity gaps, identifying potential future liquidity needs (reports should show projections using both contractual principal and interest runoffs and maturities (original maturity dates) and behavioral principal and interest runoffs and maturities (maturities attributable to the expected behaviors of customers));
  - consolidated large funds providers, identifying customer concentrations (reports should identify and aggregate major liability instruments used by large customers across all banks in the holding company); and
  - the cost of funds from all significant funding sources, enabling management to quickly compare costs.
8. Review the liquidity CFP and the minutes of ALCO meetings and board meetings. Discuss with management the adequacy of the institution's—
    - a. customization of its CFP to fit its liquidity-risk profile;
    - b. identification of potential stress events and the various levels of stress that can occur under those events;
    - c. quantitative assessment of its short-term and intermediate-term funding needs during stress events, particularly the reasonableness of the assumptions the institution used to forecast its potential liquidity needs;
    - d. comprehensiveness in forecasting cash flows under stress conditions (forecasts should incorporate OBS and payment systems and the operational implications of cash-flow forecasts);
    - e. identification of potential sources of liquidity under stress events;
    - f. operating policies and procedures, including the delineation of responsibilities, to be implemented in stress events, for communicating with various stakeholders;
    - g. prioritization of actions for responding to stress situations;
  - h. identification and use of contingent liquidity-risk triggers to monitor, on an ongoing basis, the potential for contingent liquidity events; and
  - i. testing of the operational elements of the CFP.
9. Determine whether the board and senior management have established clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits. Review policies, procedures, and reports to ascertain whether the institution's—
    - a. measurement system adequately captures and quantifies risk;
    - b. limits are comprehensive, appropriately defined, and communicated to management in a timely manner; and
    - c. risk reports are regularly and formally discussed by management and whether meeting minutes are adequately documented.
  10. Determine whether internal controls and information systems are adequately tested and reviewed by ascertaining if the institution's—
    - a. risk-measurement tools are accurate, independent, and reliable;
    - b. testing of controls is adequate and frequent enough, given the level of risk and sophistication of risk-management decisions; and
    - c. reports provide relevant information, including comments on major changes in risk profiles.
  11. Determine whether the liquidity-management function is audited internally or is evaluated by the risk-management function. Determine whether the audit and/or evaluation is independent and of sufficient scope.
  12. Determine whether audit findings and management responses to those findings are fully documented and tracked for adequate follow-up.
  13. Determine whether line management is held accountable for unsatisfactory or ineffective follow-up.
  14. Determine whether risk managers give identified material weaknesses appropriate and timely attention.
  15. Assess whether actions taken by management to deal with material weaknesses have been verified and reviewed for objectivity and adequacy by senior management or the board.
  16. Determine whether the board and senior

- management have established adequate procedures for ensuring compliance with applicable laws and regulations.
17. Assess the institution's compliance with applicable laws and regulations as they pertain to deposit accounts.
  18. Assess the institution's compliance with laws and regulations, as well as potential risk exposures arising from interbank credit exposure.
  19. Assess the institution's compliance with regulations A, D, F, and W; statutory restrictions on the use of brokered deposits; and legal restrictions on dividends. Assess whether CFPs comply with these regulations and restrictions.
  20. On the basis of the above procedures, determine whether the quality of the institution's liquidity-risk management is unsatisfactory, marginal, fair, satisfactory, or strong.

# Liquidity Risk

## Internal Control Questionnaire

Effective date October 2010

## Section 4020.4

Review the bank's internal controls, policies, practices, and procedures for managing funding liquidity risk. The bank's system should be documented completely and concisely and should include, when appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

1. Has the board of directors, consistent with its duties and responsibilities, reviewed and ratified funds-management policies, practices, and procedures that include—
  - a. clear lines of authority, responsibility, and accountability for liquidity-risk management decisions?
  - b. an articulated general liquidity strategy and approach to liquidity-risk management?
  - c. the review and approval of policies, including liquidity contingency funding plans?
  - d. the specific procedures and approvals necessary for exceptions to policies, limits, and authorizations?
  - e. established procedures for ensuring compliance with applicable laws and regulations?
2. Does senior management provide adequate oversight to manage the institution's liquidity risk?
  - a. Has senior management established clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits?
  - b. Are clear lines of responsibility and accountability delineated over liquidity-risk management and management decisionmaking?
  - c. Is there a designated asset/liability committee (ALCO) or other management decisionmaking body in which liquidity risk is appropriately discussed? Does the institution have a separate liquidity-risk management function?
  - d. Is the frequency of ALCO meetings appropriate, and are the reports presented at meetings adequate?
  - e. Does management regularly and formally discuss risk reports, and are meeting minutes and decisions adequately documented?
  - f. Is the technical and managerial expertise of management and personnel involved in liquidity management appropriate for the institution?
3. Are the institution's policies, procedures, and limits for liquidity risk appropriate and sufficiently comprehensive to adequately control the range of liquidity risk for the level of the institution's activity?
  - a. Do the policies and procedures identify the objectives and strategies of the institution's liquidity management, and do they include the institution's expected and preferred reliance on various sources of funds to meet liquidity needs under alternative scenarios?
  - b. Are policies and procedures consistent with institution practices?
  - c. Are the limits comprehensive and appropriately defined for the institution's level of activity? Are limit exceptions communicated to management in a timely manner?
  - d. Is there a formal process for setting, reassessing, and communicating the rationale for the limit structure?
  - e. Do quantitative limits and guidelines define the acceptable level of risk for the institution (i.e., maximum and targeted amounts of cash-flow mismatches, liquidity reserves, volatile liabilities, funding concentrations, etc.)?
  - f. Are the frequency and methods used to measure, monitor, and control liquidity risk specified?
4. Are liquidity-risk measurement methodologies, models, assumptions, and reports, as well as other liquidity-risk management documentation, sufficiently adequate, comprehensive, and appropriate?
  - a. Is liquidity-risk management involved in the financial institution's new-product discussions?
  - b. Has the institution developed future growth plans and ongoing funding needs, and the sources of funding to meet those needs?
  - c. Has the institution developed alternative sources of funds to be used if its future plans are not met?
  - d. Does management adequately utilize comprehensive cash-flow projections and



- supporting analysis in order to manage the institution's liquidity?
- e. Does the institution utilize appropriate summary measures and ratios that adequately reflect its liquidity-risk profile?
  - f. Do the above reports provide relevant information, including comments on major changes in risk profiles?
  - g. Does the planning and budgeting function consider liquidity requirements?
  - h. Are internal management reports concerning liquidity needs and sources of funds to meet those needs prepared regularly and reviewed, as appropriate, by senior management and the board of directors?
5. Does an independent party regularly review and evaluate the components of the liquidity-risk management function?
- a. Is the liquidity-risk management function audited internally, or is it evaluated by the risk-management function? Are the audit and/or evaluation of the liquidity-risk management process and controls independent and of sufficient scope?
  - b. Are audit findings and management responses to those findings fully documented and tracked for adequate follow-up?
- c. Do the internal controls and internal audit reviews ensure compliance with internal liquidity-management policies and procedures?
  - d. Is line management held accountable for unsatisfactory or ineffective follow-up?
  - e. Do risk managers give identified material weaknesses appropriate and timely attention? Are their actions verified and reviewed for objectivity and adequacy by senior management or the board?
6. Are internal controls and information systems adequately tested and reviewed?
- a. Are risk-measurement tools accurate, independent, and reliable?
  - b. Is the frequency for the testing of controls adequate, given the level of risk and sophistication of risk-management decisions?
7. On the basis of a composite evaluation, as evidenced by answers to the foregoing questions, are the internal controls and internal audit procedures considered adequate?

# Short-Term Liquidity Management (Federal Reserve's Primary Credit Program)

Effective date October 2009

## Section 4025.1

### LIQUIDITY-RISK MANAGEMENT USING THE FEDERAL RESERVE'S PRIMARY CREDIT PROGRAM

The Federal Reserve's primary credit program (discount window) offers depository institutions an additional source of available funds (at a rate above the target federal funds rate) for managing short-term liquidity risks.<sup>1</sup> Management should fully assess the potential role that the Federal Reserve's primary credit program might play in managing their institution's liquidity. The primary credit program can be a viable source of very short-term backup funds. Management may find it appropriate to incorporate the availability of the primary credit program into their institution's diversified liquidity-management policies, procedures, and contingency plans. The primary credit program has the following attributes that make the discount window a viable source of backup or contingency funding for short-term purposes:

- Primary credit provides a simpler, less-burdensome administrative process and a more accessible source of backup, short-term funding.
- Primary credit can enhance diversification in short-term funding contingency plans.
- Borrowings can be secured with an array of collateral, including consumer and commercial loans.
- Requests for primary credit advances can be made anytime during the day.<sup>2</sup>
- There are no restrictions on the use of short-term primary credit.

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

significant processing or lead time for pledging to the Reserve Bank.

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

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

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

It is also important to note that the Federal Reserve's primary credit facility is only one of many tools institutions may use in managing their liquidity-risk profiles. An institution's management should ensure that the institution maintains adequate access to a diversified array of readily available and confirmed funding sources,

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

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

including liquid assets such as high-grade investment securities and a diversified mix of wholesale and retail borrowings. (See SR-03-15.)

### Supervisory and Examiner Considerations

Because primary credit can serve as a viable source of backup, short-term funds, supervisors and examiners should view the occasional use of primary credit as appropriate and unexceptional. At the same time, however, supervisors and

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

Banking organizations should be attentive to the possible adverse consequences (including financial loss) of decisions based on models that are incorrect or misused and should address those consequences through active model risk management. The key aspects of an effective model risk-management framework are described in more detail below, including robust model development, implementation, and use; effective validation; and sound governance, policies, and controls. (See SR-11-7.)

### INTRODUCTION—PART I

Banks rely heavily on quantitative analysis and models in most aspects of financial decision making.<sup>1</sup> They routinely use models for a broad range of activities, including underwriting credits; valuing exposures, instruments, and positions; measuring risk; managing and safeguarding client assets; determining capital and reserve adequacy; and many other activities. In recent years, banks have applied models to more complex products and with more ambitious scope, such as enterprise-wide risk measurement, while the markets in which they are used have also broadened and changed. Changes in regulation have spurred some of the recent developments, particularly the U.S. regulatory capital rules for market, credit, and operational risk based on the framework developed by the Basel Committee on Banking Supervision. Even apart from these regulatory considerations, however, banks have been increasing the use of data-driven, quantitative decision making tools for a number of years.

The expanding use of models in all aspects of banking reflects the extent to which models can improve business decisions, but models also come with costs. There is the direct cost of devoting resources to develop and implement models properly. There are also the potential indirect costs of relying on models, such as the possible adverse consequences (including financial loss) of decisions based on models that are

incorrect or misused. Those consequences should be addressed by active management of model risk.

This guidance describes the key aspects of effective model risk management. Part II explains the purpose and scope of the guidance, and part III gives an overview of model risk management. Part IV discusses robust model development, implementation, and use. Part V describes the components of an effective validation framework. Part VI explains the salient features of sound governance, policies, and controls over model development, implementation, use, and validation. Part VII concludes.

### PURPOSE AND SCOPE—PART II

The purpose of this section is to provide comprehensive guidance for banks on effective model risk management. Rigorous model validation plays a critical role in model risk management; however, sound development, implementation, and use of models are also vital elements. Furthermore, model risk management encompasses governance and control mechanisms such as board and senior management oversight, policies and procedures, controls and compliance, and an appropriate incentive and organizational structure.

Previous guidance and other publications issued by the Office of the Comptroller of the Currency (OCC) and the Federal Reserve on the use of models pay particular attention to model validation.<sup>2</sup> Based on supervisory and industry experience over the past several years, this document expands on existing guidance—most importantly by broadening the scope to include

1. Unless otherwise indicated, *banks* refers to national banks and all other institutions for which the Office of the Comptroller of the Currency is the primary supervisor, and to bank holding companies, state member banks, and all other institutions for which the Federal Reserve Board is the primary supervisor.

2. For instance, the OCC provided guidance on model risk, focusing on model validation, in OCC 2000-16 (May 30, 2000), other bulletins, and certain subject matter booklets of the *Comptroller's Handbook*. The Federal Reserve issued SR-09-01, "Application of the Market Risk Rule in Bank Holding Companies and State Member Banks," which highlights various concepts pertinent to model risk management, including standards for validation and review, model validation documentation, and back-testing. The Federal Reserve's *Trading and Capital-Markets Activities Manual* also discusses validation and model risk management. In addition, the advanced-approaches risk-based capital rules (12 CFR 3, Appendix C; 12 CFR 208, Appendix F; and 12 CFR 225, Appendix G) contain explicit validation requirements for subject banking organizations.

all aspects of model risk management. Many banks may already have in place a large portion of these practices, but all banks should ensure that internal policies and procedures are consistent with the risk-management principles and supervisory expectations contained in this guidance. Details may vary from bank to bank, as practical application of this guidance should be customized to be commensurate with a bank's risk exposures, its business activities, and the complexity and extent of its model use. For example, steps taken to apply this guidance at a community bank using relatively few models of only moderate complexity might be significantly less involved than those at a larger bank where use of models is more extensive or complex.

## OVERVIEW OF MODEL RISK MANAGEMENT—PART III

For the purposes of this section, the term *model* refers to a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates. A *model* consists of three components: an information input component, which delivers assumptions and data to the model; a processing component, which transforms inputs into estimates; and a reporting component, which translates the estimates into useful business information. Models meeting this definition might be used for analyzing business strategies; informing business decisions; identifying and measuring risks; valuing exposures, instruments, or positions; conducting stress testing; assessing adequacy of capital; managing client assets; measuring compliance with internal limits; maintaining the formal control apparatus of the bank; meeting financial or regulatory reporting requirements; and issuing public disclosures. The definition of *model* also covers quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgment, provided that the output is quantitative in nature.<sup>3</sup>

Models are simplified representations of real-world relationships among observed characteristics, values, and events. Simplification is inevitable, due to the inherent complexity of those

relationships, but also intentional, to focus attention on particular aspects considered to be most important for a given model application. Model quality can be measured in many ways: precision, accuracy, discriminatory power, robustness, stability, and reliability, to name a few. Models are never perfect, and the appropriate metrics of quality, and the effort that should be put into improving quality, depend on the situation. For example, precision and accuracy are relevant for models that forecast future values, while discriminatory power applies to models that rank order risks. In all situations, it is important to understand a model's capabilities and limitations given its simplifications and assumptions.

The use of models invariably presents model risk, which is the potential for adverse consequences from decisions based on incorrect or misused model outputs and reports. Model risk can lead to financial loss, poor business and strategic decision making, or damage to a bank's reputation. Model risk occurs primarily for two reasons:

- The model may have fundamental errors and may produce inaccurate outputs when viewed against the design objective and intended business uses. The mathematical calculation and quantification exercise underlying any model generally involves application of theory, choice of sample design and numerical routines, selection of inputs and estimation, and implementation in information systems. Errors can occur at any point from design through implementation. In addition, shortcuts, simplifications, or approximations used to manage complicated problems could compromise the integrity and reliability of outputs from those calculations. Finally, the quality of model outputs depends on the quality of input data and assumptions, and errors in inputs or incorrect assumptions will lead to inaccurate outputs.
- The model may be used incorrectly or inappropriately. Even a fundamentally sound model producing accurate outputs consistent with the design objective of the model may exhibit high model risk if it is misapplied or misused. Models by their nature are simplifications of reality, and real-world events may prove those simplifications inappropriate. This is even more of a concern if a model is used outside the environment for which it was designed. Banks may do this intentionally as they apply

3. While outside the scope of this guidance, more qualitative approaches used by banking organizations—i.e., those not defined as models according to this guidance—should also be subject to a rigorous control process.

existing models to new products or markets, or inadvertently as market conditions or customer behavior changes. Decision makers need to understand the limitations of a model to avoid using it in ways that are not consistent with the original intent. Limitations come in part from weaknesses in the model due to its various shortcomings, approximations, and uncertainties. Limitations are also a consequence of assumptions underlying a model that may restrict the scope to a limited set of specific circumstances and situations.

Model risk should be managed like other types of risk. Banks should identify the sources of risk and assess the magnitude. Model risk increases with greater model complexity, higher uncertainty about inputs and assumptions, broader use, and larger potential impact. Banks should consider risk from individual models and in the aggregate. Aggregate model risk is affected by interaction and dependencies among models; reliance on common assumptions, data, or methodologies; and any other factors that could adversely affect several models and their outputs at the same time. With an understanding of the source and magnitude of model risk in place, the next step is to manage it properly.

A guiding principle for managing model risk is “effective challenge” of models, that is, critical analysis by objective, informed parties who can identify model limitations and assumptions and produce appropriate changes. Effective challenge depends on a combination of incentives, competence, and influence. Incentives to provide effective challenge to models are stronger when there is greater separation of that challenge from the model development process and when challenge is supported by well-designed compensation practices and corporate culture. Competence is a key to effectiveness since technical knowledge and modeling skills are necessary to conduct appropriate analysis and critique. Finally, challenge may fail to be effective without the influence to ensure that actions are taken to address model issues. Such influence comes from a combination of explicit authority, stature within the organization, and commitment and support from higher levels of management.

Even with skilled modeling and robust validation, model risk cannot be eliminated, so other tools should be used to manage model risk effectively. Among these are establishing limits on model use, monitoring model performance,

adjusting or revising models over time, and supplementing model results with other analysis and information. Informed conservatism, in either the inputs or the design of a model or through explicit adjustments to outputs, can be an effective tool, though not an excuse to avoid improving models.

As is generally the case with other risks, materiality is an important consideration in model risk management. If at some banks the use of models is less pervasive and has less impact on their financial condition, then those banks may not need as complex an approach to model risk management in order to meet supervisory expectations. However, where models and model output have a material impact on business decisions, including decisions related to risk management and capital and liquidity planning, and where model failure would have a particularly harmful impact on a bank’s financial condition, a bank’s model risk-management framework should be more extensive and rigorous.

Model risk management begins with robust model development, implementation, and use. Another essential element is a sound model validation process. A third element is governance, which sets an effective framework with defined roles and responsibilities for clear communication of model limitations and assumptions, as well as the authority to restrict model usage. Each of these elements is discussed in the following sections.

## MODEL DEVELOPMENT, IMPLEMENTATION, AND USE—PART IV

Model risk management should include disciplined and knowledgeable development and implementation processes that are consistent with the situation and goals of the model user and with bank policy. Model development is not a straightforward or routine technical process. The experience and judgment of developers, as much as their technical knowledge, greatly influence the appropriate selection of inputs and processing components. The training and experience of developers exercising such judgment affects the extent of model risk. Moreover, the modeling exercise is often a multidisciplinary activity drawing on economics, finance, statistics, mathematics, and other fields. Models are

employed in real-world markets and events and, therefore, should be tailored for specific applications and informed by business uses. In addition, a considerable amount of subjective judgment is exercised at various stages of model development, implementation, use, and validation. It is important for decision makers to recognize that this subjectivity elevates the importance of sound and comprehensive model risk-management processes.<sup>4</sup>

## Model Development and Implementation

An effective development process begins with a clear statement of purpose to ensure that model development is aligned with the intended use. The design, theory, and logic underlying the model should be well documented and generally supported by published research and sound industry practice. The model methodologies and processing components that implement the theory, including the mathematical specification and the numerical techniques and approximations, should be explained in detail with particular attention to merits and limitations. Developers should ensure that the components work as intended, are appropriate for the intended business purpose, and are conceptually sound and mathematically and statistically correct. Comparison with alternative theories and approaches is a fundamental component of a sound modeling process.

The data and other information used to develop a model are of critical importance; there should be rigorous assessment of data quality and relevance, and appropriate documentation. Developers should be able to demonstrate that such data and information are suitable for the model and that they are consistent with the theory behind the approach and with the chosen methodology. If data proxies are used, they should be carefully identified, justified, and documented. If data and information are not representative of the bank's portfolio or other characteristics, or if assumptions are made to adjust the data and information, these factors

4. Smaller banks that rely on vendor models may be able to satisfy the standards in this guidance without an in-house staff of technical, quantitative model developers. However, even if a bank relies on vendors for basic model development, the bank should still choose the particular models and variables that are appropriate to its size, scale, and lines of business and ensure the models are appropriate for the intended use.

should be properly tracked and analyzed so that users are aware of potential limitations. This is particularly important for external data and information (from a vendor or outside party), especially as they relate to new products, instruments, or activities.

An integral part of model development is testing, in which the various components of a model and its overall functioning are evaluated to determine whether the model is performing as intended. Model testing includes checking the model's accuracy, demonstrating that the model is robust and stable, assessing potential limitations, and evaluating the model's behavior over a range of input values. It should also assess the impact of assumptions and identify situations where the model performs poorly or becomes unreliable. Testing should be applied to actual circumstances under a variety of market conditions, including scenarios that are outside the range of ordinary expectations, and should encompass the variety of products or applications for which the model is intended. Extreme values for inputs should be evaluated to identify any boundaries of model effectiveness. The impact of model results on other models that rely on those results as inputs should also be evaluated. Included in testing activities should be the purpose, design, and execution of test plans, summary results with commentary and evaluation, and detailed analysis of informative samples. Testing activities should be appropriately documented.

The nature of testing and analysis will depend on the type of model and will be judged by different criteria depending on the context. For example, the appropriate statistical tests depend on specific distributional assumptions and the purpose of the model. Furthermore, in many cases statistical tests cannot unambiguously reject false hypotheses or accept true ones based on sample information. Different tests have different strengths and weaknesses under different conditions. Any single test is rarely sufficient, so banks should apply a variety of tests to develop a sound model.

Banks should ensure that the development of the more judgmental and qualitative aspects of their models is also sound. In some cases, banks may take statistical output from a model and modify it with judgmental or qualitative adjustments as part of model development. While such practices may be appropriate, banks should ensure that any such adjustments made as part of the development process are conducted in an

appropriate and systematic manner and are well documented.

Models typically are embedded in larger information systems that manage the flow of data from various sources into the model and handle the aggregation and reporting of model outcomes. Model calculations should be properly coordinated with the capabilities and requirements of information systems. Sound model risk management depends on substantial investment in supporting systems to ensure data and reporting integrity, together with controls and testing to ensure proper implementation of models, effective systems integration, and appropriate use.

## Model Use

Model use provides additional opportunity to test whether a model is functioning effectively and to assess its performance over time as conditions and model applications change. It can serve as a source of productive feedback and insights from a knowledgeable internal constituency with strong interest in having models that function well and reflect economic and business realities. Model users can provide valuable business insight during the development process. In addition, business managers affected by model outcomes may question the methods or assumptions underlying the models, particularly if the managers are significantly affected by, and do not agree with, the outcome. Such questioning can be healthy if it is constructive and causes model developers to explain and justify the assumptions and design of the models.

However, challenge from model users may be weak if the model does not materially affect their results, if the resulting changes in models are perceived to have adverse effects on the business line, or if change in general is regarded as expensive or difficult. User challenges also tend not to be comprehensive because they focus on aspects of models that have the most direct impact on the user's measured business performance or compensation, and thus may ignore other elements and applications of the models. Finally, such challenges tend to be asymmetric because users are less likely to challenge an outcome that results in an advantage for them. Indeed, users may incorrectly believe that model risk is low simply because outcomes from model-based decisions appear

favorable to the institution. Thus, the nature and motivation behind model users' input should be evaluated carefully, and banks should also solicit constructive suggestions and criticism from sources independent of the line of business using the model.

Reports used for business decision making play a critical role in model risk management. Such reports should be clear and comprehensible and take into account the fact that decision makers and modelers often come from quite different backgrounds and may interpret the contents in different ways. Reports that provide a range of estimates for different input-value scenarios and assumption values can give decision makers important indications of the model's accuracy, robustness, and stability as well as information on model limitations.

An understanding of model uncertainty and inaccuracy and a demonstration that the bank is accounting for them appropriately are important outcomes of effective model development, implementation, and use. Because they are by definition imperfect representations of reality, all models have some degree of uncertainty and inaccuracy. These can sometimes be quantified, for example, by an assessment of the potential impact of factors that are unobservable or not fully incorporated in the model, or by the confidence interval around a statistical model's point estimate. Indeed, using a range of outputs, rather than a simple point estimate, can be a useful way to signal model uncertainty and avoid spurious precision. At other times, only a qualitative assessment of model uncertainty and inaccuracy is possible. In either case, it can be prudent for banks to account for model uncertainty by explicitly adjusting model inputs or calculations to produce more severe or adverse model output in the interest of conservatism. Accounting for model uncertainty can also include judgmental conservative adjustments to model output, placing less emphasis on that model's output, or ensuring that the model is only used when supplemented by other models or approaches.<sup>5</sup>

While conservative use of models is prudent in general, banks should be careful in applying conservatism broadly or claiming to make conservative adjustments or add-ons to address

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5. To the extent that models are used to generate amounts included in public financial statements, any adjustments for model uncertainty must comply with generally accepted accounting principles.



model risk, because the impact of such conservatism in complex models may not be obvious or intuitive. Model aspects that appear conservative in one model may not be truly conservative compared with alternative methods. For example, simply picking an extreme point on a given modeled distribution may not be conservative if the distribution was misestimated or misspecified in the first place. Furthermore, initially conservative assumptions may not remain conservative over time. Therefore, banks should justify and substantiate claims that model outputs are conservative with a definition and measurement of that conservatism that is communicated to model users. In some cases, sensitivity analysis or other types of stress testing can be used to demonstrate that a model is indeed conservative. Another way in which banks may choose to be conservative is to hold an additional cushion of capital to protect against potential losses associated with model risk. However, conservatism can become an impediment to proper model development and application if it is seen as a solution that dissuades the bank from making the effort to improve the model; in addition, excessive conservatism can lead model users to discount the model outputs.

As previously explained, robust model development, implementation, and use is important to model risk management. But it is not enough for model developers and users to understand and accept the model. Because model risk is ultimately borne by the bank as a whole, the bank should objectively assess model risk and the associated costs and benefits using a sound model-validation process.

## MODEL VALIDATION—PART V

Model validation is the set of processes and activities intended to verify that models are performing as expected, in line with their design objectives and business uses. Effective validation helps ensure that models are sound. It also identifies potential limitations and assumptions and assesses their possible impact. As with other aspects of effective challenge, model validation should be performed by staff with appropriate incentives, competence, and influence.

All model components, including input, processing, and reporting, should be subject to validation; this applies equally to models developed in-house and to those purchased from, or

developed by, vendors or consultants. The rigor and sophistication of validation should be commensurate with the bank's overall use of models, the complexity and materiality of its models, and the size and complexity of the bank's operations.

Validation involves a degree of independence from model development and use. Generally, validation should be done by people who are not responsible for development or use and do not have a stake in whether a model is determined to be valid. Independence is not an end in itself but rather helps ensure that incentives are aligned with the goals of model validation. While independence may be supported by separation of reporting lines, it should be judged by actions and outcomes, since there may be additional ways to ensure objectivity and prevent bias. As a practical matter, some validation work may be most effectively done by model developers and users; it is essential, however, that such validation work be subject to critical review by an independent party, who should conduct additional activities to ensure proper validation. Overall, the quality of the process is judged by the manner in which models are subject to critical review. This could be determined by evaluating the extent and clarity of documentation, the issues identified by objective parties, and the actions taken by management to address model issues.

In addition to independence, banks can support appropriate incentives in validation through compensation practices and performance evaluation standards that are tied directly to the quality of model validations and the degree of critical, unbiased review. In addition, corporate culture plays a role if it establishes support for objective thinking and encourages questioning and challenging of decisions.

Staff doing validation should have the requisite knowledge, skills, and expertise. A high level of technical expertise may be needed because of the complexity of many models, both in structure and in application. These staff also should have a significant degree of familiarity with the line of business using the model and the model's intended use. A model's developer is an important source of information but cannot be relied on as an objective or sole source on which to base an assessment of model quality.

Staff conducting validation work should have explicit authority to challenge developers and users and to elevate their findings, including issues and deficiencies. The individual or unit to

whom those staff report should have sufficient influence or stature within the bank to ensure that any issues and deficiencies are appropriately addressed in a timely and substantive manner. Such influence can be reflected in reporting lines, title, rank, or designated responsibilities. Influence may be demonstrated by a pattern of actual instances in which models, or the use of models, have been appropriately changed as a result of validation.

The range and rigor of validation activities conducted prior to first use of a model should be in line with the potential risk presented by use of the model. If significant deficiencies are noted as a result of the validation process, use of the model should not be allowed or should be permitted only under very tight constraints until those issues are resolved. If the deficiencies are too severe to be addressed within the model's framework, the model should be rejected. If it is not feasible to conduct necessary validation activities prior to model use because of data paucity or other limitations, that fact should be documented and communicated in reports to users, senior management, and other relevant parties. In such cases, the uncertainty about the results that the model produces should be mitigated by other compensating controls. This is particularly applicable to new models and to the use of existing models in new applications.

Validation activities should continue on an ongoing basis after a model goes into use, to track known model limitations and to identify any new ones. Validation is an important check on model use during periods of benign economic and financial conditions, when estimates of risk and potential loss can become overly optimistic, and when the data at hand may not fully reflect more stressed conditions. Ongoing validation activities help to ensure that changes in markets, products, exposures, activities, clients, or business practices do not create new model limitations. For example, if credit risk models do not incorporate underwriting changes in a timely manner, flawed and costly business decisions could be made before deterioration in model performance becomes apparent.

Banks should conduct a periodic review—at least annually but more frequently if warranted—of each model to determine whether it is working as intended and if the existing validation activities are sufficient. Such a determination could simply affirm previous validation work, suggest updates to previous validation activities, or call for additional validation

activities. Material changes to models should also be subject to validation. It is generally good practice for banks to ensure that all models undergo the full validation process, as described in the following section, at some fixed interval, including updated documentation of all activities.

Effective model validation helps reduce model risk by identifying model errors, corrective actions, and appropriate use. It also provides an assessment of the reliability of a given model, based on its underlying assumptions, theory, and methods. In this way, it provides information about the source and extent of model risk. Validation also can reveal deterioration in model performance over time and can set thresholds for acceptable levels of error, through analysis of the distribution of outcomes around expected or predicted values. If outcomes fall consistently outside this acceptable range, then the models should be redeveloped.

## Key Elements of Comprehensive Validation

An effective validation framework should include three core elements:

- Evaluation of conceptual soundness, including developmental evidence
- Ongoing monitoring, including process verification and benchmarking
- Outcomes analysis, including back-testing

### *Evaluation of Conceptual Soundness*

This first element involves assessing the quality of the model design and construction. It entails review of documentation and empirical evidence supporting the methods used and variables selected for the model. Documentation and testing should convey an understanding of model limitations and assumptions. Validation should ensure that judgment exercised in model design and construction is well informed, carefully considered, and consistent with published research and with sound industry practice. Developmental evidence should be reviewed before a model goes into use and also as part of the ongoing validation process, in particular whenever there is a material change in the model.

A sound development process will produce documented evidence in support of all model

choices, including the overall theoretical construction, key assumptions, data, and specific mathematical calculations. As part of model validation, those model aspects should be subjected to critical analysis by both evaluating the quality and extent of developmental evidence and conducting additional analysis and testing as necessary. Comparison to alternative theories and approaches should be included. Key assumptions and the choice of variables should be assessed, with analysis of their impact on model outputs and particular focus on any potential limitations. The relevance of the data used to build the model should be evaluated to ensure that it is reasonably representative of the bank's portfolio or market conditions, depending on the type of model. This is an especially important exercise when a bank uses external data or the model is used for new products or activities.

Where appropriate to the particular model, banks should employ sensitivity analysis in model development and validation to check the impact of small changes in inputs and parameter values on model outputs to make sure they fall within an expected range. Unexpectedly large changes in outputs in response to small changes in inputs can indicate an unstable model. Varying several inputs simultaneously as part of sensitivity analysis can provide evidence of unexpected interactions, particularly if the interactions are complex and not intuitively clear. Banks benefit from conducting model stress testing to check performance over a wide range of inputs and parameter values, including extreme values, to verify that the model is robust. Such testing helps establish the boundaries of model performance by identifying the acceptable range of inputs as well as conditions under which the model may become unstable or inaccurate.

Management should have a clear plan for using the results of sensitivity analysis and other quantitative testing. If testing indicates that the model may be inaccurate or unstable in some circumstances, management should consider modifying certain model properties, putting less reliance on its outputs, placing limits on model use, or developing a new approach.

Qualitative information and judgment used in model development should be evaluated, including the logic, judgment, and types of information used, to establish the conceptual soundness of the model and set appropriate conditions for its use. The validation process should ensure that qualitative, judgmental assessments are con-

ducted in an appropriate and systematic manner, are well supported, and are documented.

### *Ongoing Monitoring*

The second core element of the validation process is ongoing monitoring. Such monitoring confirms that the model is appropriately implemented and is being used and is performing as intended.

Ongoing monitoring is essential to evaluate whether changes in products, exposures, activities, clients, or market conditions necessitate adjustment, redevelopment, or replacement of the model and to verify that any extension of the model beyond its original scope is valid. Any model limitations identified in the development stage should be regularly assessed over time, as part of ongoing monitoring. Monitoring begins when a model is first implemented in production systems for actual business use. This monitoring should continue periodically over time, with a frequency appropriate to the nature of the model, the availability of new data or modeling approaches, and the magnitude of the risk involved. Banks should design a program of ongoing testing and evaluation of model performance along with procedures for responding to any problems that appear. This program should include process verification and benchmarking.

Process verification checks that all model components are functioning as designed. It includes verifying that internal and external data inputs continue to be accurate, complete, consistent with model purpose and design, and of the highest quality available. Computer code implementing the model should be subject to rigorous quality and change control procedures to ensure that the code is correct, that it cannot be altered except by approved parties, and that all changes are logged and can be audited. System integration can be a challenge and deserves special attention because the model processing component often draws from various sources of data, processes large amounts of data, and then feeds into multiple data repositories and reporting systems. User-developed applications, such as spreadsheets or ad hoc database applications used to generate quantitative estimates, are particularly prone to model risk. As the content or composition of information changes over time, systems may need to be updated to reflect any changes in the data or its use. Reports derived from model outputs should

be reviewed as part of validation to verify that they are accurate, complete, and informative, and that they contain appropriate indicators of model performance and limitations.

Many of the tests employed as part of model development should be included in ongoing monitoring and be conducted on a regular basis to incorporate additional information as it becomes available. New empirical evidence or theoretical research may suggest the need to modify or even replace original methods. Analysis of the integrity and applicability of internal and external information sources, including information provided by third-party vendors, should be performed regularly.

Sensitivity analysis and other checks for robustness and stability should likewise be repeated periodically. They can be as useful during ongoing monitoring as they are during model development. If models only work well for certain ranges of input values, market conditions, or other factors, they should be monitored to identify situations where these constraints are approached or exceeded.

Ongoing monitoring should include the analysis of overrides with appropriate documentation. In the use of virtually any model, there will be cases where model output is ignored, altered, or reversed based on the expert judgment of model users. Such overrides are an indication that, in some respect, the model is not performing as intended or has limitations. Banks should evaluate the reasons for overrides and track and analyze override performance. If the rate of overrides is high, or if the override process consistently improves model performance, it is often a sign that the underlying model needs revision or redevelopment.

Benchmarking is the comparison of a given model's inputs and outputs to estimates from alternative internal or external data or models. It can be incorporated in model development as well as in ongoing monitoring. For credit-risk models, examples of benchmarks include models from vendor firms or industry consortia and data from retail credit bureaus. Pricing models for securities and derivatives often can be compared with alternative models that are more accurate or comprehensive but also too time-consuming to run on a daily basis. Whatever the source, benchmark models should be rigorous, and benchmark data should be accurate and complete to ensure a reasonable comparison.

Discrepancies between the model output and benchmarks should trigger investigation into the

sources and degree of the differences, and examination of whether they are within an expected or appropriate range given the nature of the comparison. The results of that analysis may suggest revisions to the model. However, differences do not necessarily indicate that the model is in error. The benchmark itself is an alternative prediction, and the differences may be due to the different data or methods used. If the model and the benchmark match well, that is evidence in favor of the model, but it should be interpreted with caution so the bank does not get a false degree of comfort.

### *Outcomes Analysis*

The third core element of the validation process is outcomes analysis, a comparison of model outputs to corresponding actual outcomes. The precise nature of the comparison depends on the objectives of a model and might include an assessment of the accuracy of estimates or forecasts, an evaluation of rank-ordering ability, or other appropriate tests. In all cases, such comparisons help to evaluate model performance by establishing expected ranges for those actual outcomes in relation to the intended objectives and assessing the reasons for observed variation between the two. If outcomes analysis produces evidence of poor performance, the bank should take action to address those issues. Outcomes analysis typically relies on statistical tests or other quantitative measures. It can also include expert judgment to check the intuition behind the outcomes and confirm that the results make sense. When a model itself relies on expert judgment, quantitative outcomes analysis helps to evaluate the quality of that judgment. Outcomes analysis should be conducted on an ongoing basis to test whether the model continues to perform in line with design objectives and business uses.

A variety of quantitative and qualitative testing and analytical techniques can be used in outcomes analysis. The choice of technique should be based on the model's methodology, and its complexity, data availability, and the magnitude of potential model risk to the bank. Outcomes analysis should involve a range of tests because any individual test will have weaknesses. For example, some tests are better at checking a model's ability to rank-order or segment observations on a relative basis, whereas others are better at checking absolute forecast

accuracy. Tests should be designed for each situation, as not all will be effective or feasible in every circumstance, and attention should be paid to choosing the appropriate type of outcomes analysis for a particular model.

Models are regularly adjusted to take into account new data or techniques, or because of deterioration in performance. Parallel outcomes analysis, under which both the original and adjusted models' forecasts are tested against realized outcomes, provides an important test of such model adjustments. If the adjusted model does not outperform the original model, developers, users, and reviewers should realize that additional changes—or even a wholesale redesign—are likely necessary before the adjusted model replaces the original one.

Back-testing is one form of outcomes analysis; specifically, it involves the comparison of actual outcomes with model forecasts during a sample time period not used in model development and at an observation frequency that matches the forecast horizon or performance window of the model. The comparison is generally done using expected ranges or statistical confidence intervals around the model forecasts. When outcomes fall outside those intervals, the bank should analyze the discrepancies and investigate the causes that are significant in terms of magnitude or frequency. The objective of the analysis is to determine whether differences stem from the omission of material factors from the model, whether they arise from errors with regard to other aspects of model specification such as interaction terms or assumptions of linearity, or whether they are purely random and thus consistent with acceptable model performance. Analysis of in-sample fit and of model performance in holdout samples (data set aside and not used to estimate the original model) are important parts of model development but are not substitutes for back-testing.

A well-known example of back-testing is the evaluation of value-at-risk (VaR), in which actual profit and loss is compared with a model forecast loss distribution. Significant deviation in expected versus actual performance and unexplained volatility in the profits and losses of trading activities may indicate that hedging and pricing relationships are not adequately measured by a given approach. Along with measuring the frequency of losses in excess of a single VaR percentile estimator, banks should use other tests, such as assessing any cluster-

ing of exceptions and checking the distribution of losses against other estimated percentiles.

Analysis of the results of even high-quality and well-designed back-testing can pose challenges, since it is not a straightforward, mechanical process that always produces unambiguous results. The purpose is to test the model, not individual forecast values. Back-testing may entail analysis of a large number of forecasts over different conditions at a point in time or over multiple time periods. Statistical testing is essential in such cases, yet such testing can pose challenges in both the choice of appropriate tests and the interpretation of results; banks should support and document both the choice of tests and the interpretation of results.

Models with long forecast horizons should be back-tested, but given the amount of time it would take to accumulate the necessary data, that testing should be supplemented by evaluation over shorter periods. Banks should employ outcomes analysis consisting of “early warning” metrics designed to measure performance beginning very shortly after model introduction and trend analysis of performance over time. These outcomes analysis tools are not substitutes for back-testing, which should still be performed over the longer time period, but rather are very important complements.

Outcomes analysis and the other elements of the validation process may reveal significant errors or inaccuracies in model development or outcomes that consistently fall outside the bank's predetermined thresholds of acceptability. In such cases, model adjustment, recalibration, or redevelopment is warranted. Adjustments and recalibration should be governed by the principle of conservatism and should undergo independent review.

Material changes in model structure or technique, and all model redevelopment, should be subject to validation activities of appropriate range and rigor before implementation. At times, banks may have a limited ability to use key model validation tools like back-testing or sensitivity analysis for various reasons, such as lack of data or of price observability. In those cases, even more attention should be paid to the model's limitations when considering the appropriateness of model usage, and senior management should be fully informed of those limitations when using the models for decision making. Such scrutiny should be applied to individual models and models in the aggregate.



## Validation of Vendor and Other Third-Party Products

The widespread use of vendor and other third-party products—including data, parameter values, and complete models—poses unique challenges for validation and other model risk-management activities because the modeling expertise is external to the user and because some components are considered proprietary. Vendor products should nevertheless be incorporated into a bank's broader model risk-management framework, following the same principles as applied to in-house models, although the process may be somewhat modified.

As a first step, banks should ensure that there are appropriate processes in place for selecting vendor models. Banks should require the vendor to provide developmental evidence explaining the product components, design, and intended use, to determine whether the model is appropriate for the bank's products, exposures, and risks. Vendors should provide appropriate testing results that show their product works as expected. They should also clearly indicate the model's limitations and assumptions and where the product's use may be problematic. Banks should expect vendors to conduct ongoing performance monitoring and outcomes analysis, with disclosure to their clients, and to make appropriate modifications and updates over time.

Banks are expected to validate their own use of vendor products. External models may not allow full access to computer coding and implementation details, so the bank may have to rely more on sensitivity analysis and benchmarking. Vendor models are often designed to provide a range of capabilities and so may need to be customized by a bank for its particular circumstances. A bank's customization choices should be documented and justified as part of validation. If vendors provide input data or assumptions, or use them to build models, their relevance for the bank's situation should be investigated. Banks should obtain information regarding the data used to develop the model and assess the extent to which that data are representative of the bank's situation. The bank also should conduct ongoing monitoring and outcomes analysis of vendor model performance using the bank's own outcomes.

Systematic procedures for validation help the bank to understand the vendor product and its capabilities, applicability, and limitations. Such

detailed knowledge is necessary for basic controls of bank operations. It is also very important for the bank to have as much knowledge in-house as possible, in case the vendor or the bank terminates the contract for any reason, or if the vendor is no longer in business. Banks should have contingency plans for instances when the vendor model is no longer available or cannot be supported by the vendor.

## GOVERNANCE, POLICIES, AND CONTROLS—PART VI

Developing and maintaining strong governance, policies, and controls over the model risk-management framework is fundamentally important to its effectiveness. Even if model development, implementation, use, and validation are satisfactory, a weak governance function will reduce the effectiveness of overall model risk management. A strong governance framework provides explicit support and structure to risk-management functions through policies defining relevant risk-management activities, procedures that implement those policies, allocation of resources, and mechanisms for evaluating whether policies and procedures are being carried out as specified. Notably, the extent and sophistication of a bank's governance function is expected to align with the extent and sophistication of model usage.

### Board of Directors and Senior Management

Model risk governance is provided at the highest level by the board of directors and senior management when they establish a bank-wide approach to model risk management. As part of their overall responsibilities, a bank's board and senior management should establish a strong model risk-management framework that fits into the broader risk management of the organization. That framework should be grounded in an understanding of model risk—not just for individual models but also in the aggregate. The framework should include standards for model development, implementation, use, and validation.

While the board is ultimately responsible, it generally delegates to senior management the responsibility for executing and maintaining an

effective model risk-management framework. Duties of senior management include establishing adequate policies and procedures and ensuring compliance, assigning competent staff, overseeing model development and implementation, evaluating model results, ensuring effective challenge, reviewing validation and internal audit findings, and taking prompt remedial action when necessary. In the same manner as for other major areas of risk, senior management, directly and through relevant committees, is responsible for regularly reporting to the board on significant model risk, from individual models and in the aggregate, and on compliance with policy. Board members should ensure that the level of model risk is within their tolerance and should direct changes where appropriate. These actions will set the tone for the whole organization about the importance of model risk and the need for active model risk management.

## Policies and Procedures

Consistent with good business practices and existing supervisory expectations, banks should formalize model risk-management activities with policies and the procedures to implement them. Model risk-management policies should be consistent with this guidance and also be commensurate with the bank's relative complexity, business activities, corporate culture, and overall organizational structure. The board or its delegates should approve model risk-management policies and review them annually to ensure consistent and rigorous practices across the organization. Those policies should be updated as necessary to ensure that model risk-management practices remain appropriate and keep current with changes in market conditions, bank products and strategies, bank exposures and activities, and practices in the industry. All aspects of model risk management should be covered by suitable policies, including model and model risk definitions; assessment of model risk; acceptable practices for model development, implementation, and use; appropriate model validation activities; and governance and controls over the model risk-management process.

Policies should emphasize testing and analysis and promote the development of targets for model accuracy, standards for acceptable levels of discrepancies, and procedures for review of, and response to, unacceptable discrepancies.

They should include a description of the processes used to select and retain vendor models, including the people who should be involved in such decisions.

The prioritization, scope, and frequency of validation activities should be addressed in these policies. They should establish standards for the extent of validation that should be performed before models are put into production and the scope of ongoing validation. The policies should also detail the requirements for validation of vendor models and third-party products. Finally, they should require maintenance of detailed documentation of all aspects of the model risk-management framework, including an inventory of models in use, results of the modeling and validation processes, and model issues and their resolution.

Policies should identify the roles and assign responsibilities within the model risk-management framework with clear detail on staff expertise, authority, reporting lines, and continuity. They should also outline controls on the use of external resources for validation and compliance and specify how that work will be integrated into the model risk-management framework.

## Roles and Responsibilities

Conceptually, the roles in model risk management can be divided among ownership, controls, and compliance. While there are several ways in which banks can assign the responsibilities associated with these roles, it is important that reporting lines and incentives be clear, with potential conflicts of interest identified and addressed.

Business units are generally responsible for the model risk associated with their business strategies. The role of model owner involves ultimate accountability for model use and performance within the framework set by bank policies and procedures. Model owners should be responsible for ensuring that models are properly developed, implemented, and used. The model owner should also ensure that models in use have undergone appropriate validation and approval processes, promptly identify new or changed models, and provide all necessary information for validation activities.

Model risk taken by business units should be controlled. The responsibilities for risk controls

may be assigned to individuals, committees, or a combination of the two, and include risk measurement, limits, and monitoring. Other responsibilities include managing the independent validation and review process to ensure that effective challenge takes place. Appropriate resources should be assigned for model validation and for guiding the scope and prioritization of work. Issues and problems identified through validation and other forms of oversight should be communicated by risk-control staff to relevant individuals and business users throughout the organization, including senior management, with a plan for corrective action. Control staff should have the authority to restrict the use of models and monitor any limits on model usage. While they may grant exceptions to typical procedures of model validation on a temporary basis, that authority should be subject to other control mechanisms, such as timelines for completing validation work and limits on model use.

Compliance with policies is an obligation of model owners and risk-control staff, and there should be specific processes in place to ensure that these roles are being carried out effectively and in line with policy. Documentation and tracking of activities surrounding model development, implementation, use, and validation are needed to provide a record that makes compliance with policy transparent.

## Internal Audit

A bank's internal audit function should assess the overall effectiveness of the model risk-management framework, including the framework's ability to address both types of model risk for individual models and in the aggregate. Findings from internal audit related to models should be documented and reported to the board or its appropriately delegated agent. Banks should ensure that internal audit operates with the proper incentives, has appropriate skills, and has adequate stature in the organization to assist in model risk management. Internal audit's role is not to duplicate model risk-management activities. Instead, its role is to evaluate whether model risk management is comprehensive, rigorous, and effective. To accomplish this evaluation, internal audit staff should possess sufficient expertise in relevant modeling concepts as well as their use in particular business lines. If some internal audit staff perform certain valida-

tion activities, then they should not be involved in the assessment of the overall model risk-management framework.

Internal audit should verify that acceptable policies are in place and that model owners and control groups comply with those policies. Internal audit should also verify records of model use and validation to test whether validations are performed in a timely manner and whether models are subject to controls that appropriately account for any weaknesses in validation activities. Accuracy and completeness of the model inventory should be assessed. In addition, processes for establishing and monitoring limits on model usage should be evaluated. Internal audit should determine whether procedures for updating models are clearly documented and test whether those procedures are being carried out as specified. Internal audit should check that model owners and control groups are meeting documentation standards, including risk reporting. Additionally, internal audit should perform assessments of supporting operational systems and evaluate the reliability of data used by models.

Internal audit also has an important role in ensuring that validation work is conducted properly and that appropriate effective challenge is being carried out. It should evaluate the objectivity, competence, and organizational standing of the key validation participants, with the ultimate goal of ascertaining whether those participants have the right incentives to discover and report deficiencies. Internal audit should review validation activities conducted by internal and external parties with the same rigor to see if those activities are being conducted in accordance with this guidance.

## External Resources

Although model risk management is an internal process, a bank may decide to engage external resources to help execute certain activities related to the model risk-management framework. These activities could include model validation and review, compliance functions, or other activities in support of internal audit. These resources may provide added knowledge and another level of critical and effective challenge, which may improve the internal model development and risk-management processes. However, this potential benefit should be weighed against the



added costs for such resources and the added time that external parties require to understand internal data, systems, and other relevant bank-specific circumstances.

Whenever external resources are used, the bank should specify the activities to be conducted in a clearly written and agreed-upon scope of work. A designated internal party from the bank should be able to understand and evaluate the results of validation and risk-control activities conducted by external resources. The internal party is responsible for verifying that the agreed upon scope of work has been completed; evaluating and tracking identified issues and ensuring they are addressed; and making sure that completed work is incorporated into the bank's overall model risk-management framework. If the external resources are only utilized to do a portion of validation or compliance work, the bank should coordinate internal resources to complete the full range of work needed. The bank should have a contingency plan in case an external resource is no longer available or is unsatisfactory.

## Model Inventory

Banks should maintain a comprehensive set of information for models implemented for use, under development for implementation, or recently retired. While each line of business may maintain its own inventory, a specific party should also be charged with maintaining a firm-wide inventory of all models, which should assist a bank in evaluating its model risk in the aggregate. Any variation of a model that warrants a separate validation should be included as a separate model and cross-referenced with other variations.

While the inventory may contain varying levels of information, given different model complexity and the bank's overall level of model usage, the following are some general guidelines. The inventory should describe the purpose and products for which the model is designed, actual or expected usage, and any restrictions on use. It is useful for the inventory to list the type and source of inputs used by a given model and underlying components (which may include other models), as well as model outputs and their intended use. It should also indicate whether models are functioning properly, provide a description of when they were

last updated, and list any exceptions to policy. Other items include the names of individuals responsible for various aspects of the model development and validation; the dates of completed and planned validation activities; and the time frame during which the model is expected to remain valid.

## Documentation

Without adequate documentation, model risk assessment and management will be ineffective. Documentation of model development and validation should be sufficiently detailed so that parties unfamiliar with a model can understand how the model operates, its limitations, and its key assumptions. Documentation provides for continuity of operations, makes compliance with policy transparent, and helps track recommendations, responses, and exceptions. Developers, users, control and compliance units, and supervisors are all served by effective documentation. Banks can benefit from advances in information and knowledge management systems and electronic documentation to improve the organization, timeliness, and accessibility of the various records and reports produced in the model risk-management process.

Documentation takes time and effort, and model developers and users who know the models well may not appreciate its value. Banks should therefore provide incentives to produce effective and complete model documentation. Model developers should have responsibility during model development for thorough documentation, which should be kept up-to-date as the model and application environment changes. In addition, the bank should ensure that other participants in model risk-management activities document their work, including ongoing monitoring, process verification, benchmarking, and outcomes analysis. Also, line of business or other decision makers should document information leading to selection of a given model and its subsequent validation. For cases in which a bank uses models from a vendor or other third party, it should ensure that appropriate documentation of the third-party approach is available so that the model can be appropriately validated.

Validation reports should articulate model aspects that were reviewed, highlighting potential deficiencies over a range of financial and

economic conditions, and determining whether adjustments or other compensating controls are warranted. Effective validation reports include clear executive summaries, with a statement of model purpose and an accessible synopsis of model and validation results, including major limitations and key assumptions.

## CONCLUSION—PART VII

Section 4027.1 provides comprehensive guidance on effective model risk management. Many of the activities described are common industry

practice. But all banks should confirm that their practices conform to the principles in this guidance for model development, implementation, and use, as well as model validation. Banks should also ensure that they maintain strong governance and controls to help manage model risk, including internal policies and procedures that appropriately reflect the risk-management principles described in this guidance. Details of model risk-management practices may vary from bank to bank, as practical application of this guidance should be commensurate with a bank's risk exposures, its business activities, and the extent and complexity of its model use.

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

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

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

While the objectives of securitization may vary from institution to institution, there are

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

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

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

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

Unforeseen market events that affect the discount rate or performance of receivables supporting a retained interest can swiftly and dramatically alter its value. Without appropriate internal controls and independent oversight, an institution that securitizes assets may inappropriately generate "paper profits" or mask actual losses through flawed loss assumptions, inaccurate prepayment rates, and inappropriate dis-

count rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements; substantial write-downs of retained interests; and, if retained interests represent an excessive concentration of the sponsoring institution's capital, the institution's demise.

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

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

1. See Statement of Financial Accounting Standards No. 166, "Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140 (FAS 166)" and Statement of Financial Accounting Standards No. 167, "Amendments to FASB Interpretation No. 146(R) (FAS 167)." Among other things, FAS 166 and FAS 167 modified the accounting treatment under U. S. generally accepted accounting principles of certain structured finance transactions involving a special purpose entity. See also FASB Statement No. 157, "Fair Value Measurements."

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

to originate or acquire additional loans or other assets for securitization, and the process is repeated. Thus, for the same volume of loan originations, securitization results in lower assets and liabilities compared with traditional lending activities.

### THE SECURITIZATION PROCESS

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

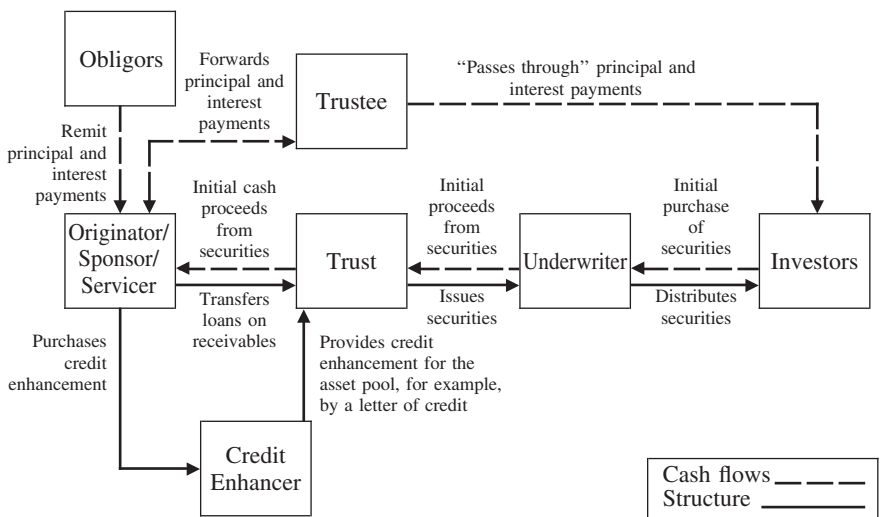
Each issue of ABS has a servicer that is responsible for collecting interest and principal payments on the loans or leases in the underlying pool of assets and for transmitting these funds to investors (or a trustee representing

them). A trustee is responsible for monitoring the activities of the servicer to ensure that it properly fulfills its role.

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

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

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



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

## Credit Enhancement

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

A seller may also arrange for a third party to provide credit enhancement in an asset securiti-

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

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

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

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

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



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

## TYPES OF ASSET-BACKED SECURITIES

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

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

pay-through structure resulted from the desire to broaden the marketability of these securities to investors who were interested in maturities other than those generally associated with pass-through securities.

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

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

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

## RISKS ASSOCIATED WITH ASSET SECURITIZATION

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

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

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

## Investor-Specific Risks

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

## Issuer-Specific Risks

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

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

## Servicer-Specific Risks

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

## ACCOUNTING ISSUES

### Sale or Borrowing Treatment

Asset-securitization transactions are frequently structured to obtain certain accounting treatments, which in turn affect reported measures of profitability and capital adequacy. In transferring assets into a pool to serve as collateral for ABS, a key question is whether the transfer should be treated as a sale of the assets or as a



collateralized borrowing, that is, a financing transaction secured by assets. Treating these transactions as a sale of assets results in their being removed from the banking organization's balance sheet, thus reducing total assets relative to earnings and capital, and thereby producing higher performance and capital ratios.<sup>5</sup> Treating these transactions as financings, however, means that the assets in the pool remain on the balance sheet and are subject to capital requirements and the related liabilities-to-reserve requirements.<sup>6</sup>

## Valuation and Modeling Processes for Retained Interests

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

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

The method and key assumptions used to value the retained interests and servicing assets or liabilities must be reasonable and fully documented. The key assumptions in all valuation

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

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

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

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

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

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

7. See FAS 140.

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

### *Use of Outside Parties*

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

### Market Discipline and Disclosures

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

of sound disclosures include—

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

### CAPITAL ADEQUACY

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

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

Examiners should review the substance of securitizations when assessing underlying risk exposures. For example, partial, first-loss direct-

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

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

## RISK-BASED CAPITAL PROVISIONS AFFECTING ASSET SECURITIZATION

The risk-based capital framework assigns risk weights to loans, ABS, off-balance-sheet credit enhancements, and other assets related to securitization.<sup>9</sup> Second, banks that transfer assets with recourse to the seller as part of the securitization process are explicitly required to hold capital against their off-balance-sheet credit

exposures. However, the specific capital requirement will depend on the amount of recourse retained by the transferring institution and the type of asset sold with recourse. Third, banking organizations that provide credit enhancement to asset-securitization issues through standby letters of credit or by other means must hold capital against the related off-balance-sheet credit exposure.

## Assigning Risk Weights

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

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

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

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

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

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

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

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

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

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

While not set forth specifically in the risk-based capital guidelines, securities backed by student loans that meet the above-mentioned criteria may also be considered an indirect holding of the underlying assets and assigned to the same risk category as those assets. For instance, the U.S. Department of Education conditionally guarantees banks originating student loans for 98 percent of each loan under the Federal Family Education Loan Program. The

guaranteed portion of the student loans is eligible for the 20 percent risk category. Therefore, senior ABS that are supported solely by student loans that are conditionally guaranteed by the Department of Education and that meet the four criteria listed above may be assigned to the 20 percent risk category to the extent they are guaranteed. As with mortgage-backed securities, subordinated student loan-backed securities and securities backed by pools of conditionally guaranteed and nonguaranteed student loans would be assigned to the 100 percent risk category.

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

## Recourse Obligations

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

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

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

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

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

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

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

- credit-enhancing representations and warranties made on the transferred assets
- loan-servicing assets retained under an agreement that requires the bank to be responsible

for credit losses associated with the loans being serviced (mortgage-servicer cash advances that meet the conditions of section III.B.3.a.viii. of the capital adequacy guidelines (12 CFR 208, appendix A) are not recourse arrangements)

- retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets
- assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet
- loan strips sold without contractual recourse when the maturity of the transferred loan is shorter than the maturity of the commitment under which the loan is drawn
- credit derivatives issued that absorb more than the bank's pro rata share of losses from the transferred assets
- clean-up calls at inception that are greater than 10 percent of the balance of the original pool of transferred loans (clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the bank are not recourse arrangements)

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

### *Implicit Recourse Provided to Asset Securitizations*

Implicit recourse arises when a bank provides

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

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

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

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

Particular attention should be paid to revolving securitizations, such as those used for credit card lines and home equity lines of credit, in

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

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

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

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

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

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

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

#### Account removal: Example 1a

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

The bank enters into a contract to sell the specified credit card accounts before the receivables are removed from the trust. The terms of the transaction are arm's length, wherein the bank will sell the receivables at market value. The bank separately agrees to purchase the receivables from the trust at this same price. Therefore, no loss is incurred as a result of removing the receivables from the trust. The bank will only remove receivables from the trust

that are due from customers located in the geographic areas where the bank lacks a significant market presence, and it will remove all such receivables from the trust.

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

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

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

#### Account removal: Example 1b

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

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

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

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

Additions of future assets or receivables:  
Example 2a

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

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

Additions of future assets or receivables:  
Example 2b

*Facts.* A bank established a credit card master trust. The receivables from the accounts placed in the trust were, on average, of lesser quality than the receivables from accounts retained on the bank's balance sheet. Under the criteria for selecting the receivables to be transferred to the master trust, the bank was prevented from including the better-performing affinity accounts in the initial pool of accounts because the affinity-relationship contract was expiring. The bank

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

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

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

Additions of future assets or receivables:  
Example 2c

*Facts.* A bank establishes a credit card master trust composed of receivables from accounts that were generally of lower quality than the receivables retained on the bank's balance sheet. The difference in the two portfolios is primarily due to logistical and operational problems that



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

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

*Analysis.* The actions described above do not constitute implicit recourse for regulatory capital purposes. None of the noncontractual actions results in a loss or exposes the bank's earnings or capital to the risk of loss. Because of the margin compression, the bank is obligated to increase the spread accounts in conformance with the terms and conditions of the securitization documents. To the extent this results in an increase in the value of the subordinated spread accounts (residual interests) on the bank's balance sheet, the bank will need to hold additional capital on a dollar-for-dollar basis for the additional credit risk it retains. In contrast, if the

bank increased the spread accounts beyond its contractual obligation under the securitization documents in order to provide additional protection to investors, this action would be considered a form of implicit recourse. None of the other actions the bank took would affect the bank's earnings or capital:

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

Modification of loan-repayment terms:

#### Example 3

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

*Analysis.* The modification of terms and repurchase of loans held by the trust constitutes implicit recourse for regulatory capital pur-

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

Servicer's payment of deficiency balances:  
Example 4

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

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

Reimbursement of credit enhancer's actual losses: Example 5

*Facts.* A bank sponsoring a securitization arranges for an unrelated third party to provide a first-loss credit enhancement, such as a financial standby letter of credit that will cover losses up to the first 10 percent of the securitized assets. The bank agrees to pay a fixed amount as an annual premium for this credit enhancement.

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

The third party initially covers actual losses that occur in the underlying asset pool in accordance with its contractual commitment under the letter of credit. Later, the selling bank agrees not only to pay the credit enhancer the annual premium on the credit enhancement, but also to reimburse the credit enhancer for the losses it absorbed during the preceding year. This reimbursement for actual losses was not originally provided for in the contractual arrangement between the bank and the credit-enhancement provider.

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

### *Low-Level Exposure*

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

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

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

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

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

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

establish, pursuant to GAAP, a noncapital reserve sufficient to meet the reasonably estimated liability under their recourse arrangements.

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

## Standby Letters of Credit

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

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

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

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

## Concentration Limits Imposed on Residual Interests

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

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

A bank has purchased and retained on its balance sheet credit-enhancing I/O strips with a face amount of \$100, and it has tier 1 capital of \$320 (before any disallowed servicing assets,

disallowed purchased credit-card relationships, disallowed credit-enhancing I/O strips, disallowed deferred tax assets, and amounts of nonfinancial equity investments required to be deducted). To determine the amount of credit-enhancing I/O strips that fall within the concentration limit, the bank would multiply the tier 1 capital of \$320 by 25 percent, which is \$80. The amount of credit-enhancing I/O strips that exceeds the concentration limit, in this case \$20, is deducted from tier 1 capital for risk-based and leverage capital calculations and from assets.

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

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

Normally, a sponsor will eventually receive any excess cash flow remaining from securitizations after investor interests have been met. As previously stated, residual interests are vulnerable to sudden and sizeable write-downs that can hinder a bank's access to the capital markets; damage its reputation in the marketplace; and, in some cases, threaten its solvency. An institution's board of directors and management are expected to develop and implement policies

that limit the amount of residual interests that may be carried as a percentage of total equity capital, based on the results of their valuation and modeling processes. Well-constructed internal limits also lessen the incentives for an institution's personnel to engage in activities designed to generate near-term "paper profits" that may be at the expense of the institution's long-term financial position and reputation.

## Asset-Backed Commercial Paper Programs

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

An asset-backed commercial paper (ABCP) program typically is a program through which a bank provides funding to its corporate customers by sponsoring and administering a bankruptcy-remote special-purpose entity that purchases asset pools from, or extends loans to, those customers.<sup>15</sup> The asset pools in an ABCP

program might include, for example, trade receivables, consumer loans, or ABS. The ABCP program raises cash to provide funding to the bank's customers through the issuance of externally rated commercial paper into the market. Typically, the sponsoring bank provides liquidity and credit enhancements to the ABCP program. These enhancements aid the program in obtaining high credit ratings that facilitate the issuance of the commercial paper.<sup>16</sup>

Banks consolidating ABCP program assets must include all of the program assets (mostly receivables and securities) and liabilities (mainly commercial paper) on their balance sheets for purposes of the bank Reports of Condition and Income (Call Reports).

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

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

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

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

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

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

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

The Board's risk-based capital guidelines impose a 10 percent credit-conversion factor on unused portions of eligible short-term liquidity facilities supporting ABCP. Under the risk-based capital guidelines and the Board's interpretations thereof, the credit conversion factor for an eligible ABCP liquidity facility is based on whether the facility has an original maturity of one year or less.<sup>17</sup> A 50 percent credit-conversion factor applies to eligible ABCP liquidity facilities having a maturity greater than one year. To be an eligible ABCP liquidity facility and qualify for the 10 or 50 percent credit-conversion factor, the facility must be subject to an asset quality test at the time of inception that does not permit funding against (1) assets that are 90 days or more past due, (2) assets that are in default, and (3) assets or exposures that are externally rated below investment grade at the time of funding if the assets or exposures were externally rated at the inception of the facility. However, a liquidity facility may also be an eligible liquidity facility if it funds against assets that are guaranteed—either conditionally or unconditionally—by the U.S. government, U.S. government agencies, or by an OECD central government, regardless of whether the assets are 90 days past due, in default, or externally rated investment grade.

The 10 or 50 percent credit-conversion factors apply, regardless of whether the structure issuing the ABCP meets the rule's definition of an ABCP program. For example, a capital charge would apply to an eligible short-term liquidity facility that provides liquidity support to ABCP where the ABCP constitutes less than 50 percent of the securities issued by the program, thus causing the issuing structure not to meet the rule's definition of an ABCP program. However, if a bank (1) does not meet this definition and must include the program's assets in its risk-weighted asset base or (2) otherwise chooses to include the program's assets in risk-weighted assets, then no risk-based capital requirement

will be assessed against any liquidity facilities provided by the bank that support the program's ABCP. Ineligible liquidity facilities will be treated as recourse obligations or direct-credit substitutes for the purposes of the Board's risk-based capital guidelines.

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

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

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

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

quidity facilities that comprise the same program assets.

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

*Asset-quality test.* For a liquidity facility, either short- or long-term, that supports ABCP *not* to be considered a recourse obligation or a direct-credit substitute, it must meet the risk-based capital rule's definition of an *eligible ABCP liquidity facility*. An eligible ABCP liquidity facility must meet a reasonable asset-quality test that, among other things, precludes funding against assets that are 90 days or more past due or in default. When assets are 90 days or more past due, they typically have deteriorated to the point where there is an extremely high probability of default. Assets that are 90 days past due, for example, often must be placed on non-accrual status in accordance with the agencies' Uniform Retail Credit Classification and Account Management Policy.<sup>18</sup> Further, they generally must also be classified substandard under that policy.

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

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

An ABCP liquidity facility is considered to be in compliance with the requirement for an asset

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

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

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

Recourse directly to the seller, other than the funded credit enhancements enumerated above, regardless of the seller's external credit rating, is not an acceptable form of credit enhancement

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

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

for purposes of satisfying the asset quality test. Seller recourse—for example, a seller's agreement to buy back nonperforming or defaulted loans or downgraded securities—may expose the liquidity provider to an increased level of credit risk. A decline in the performance of assets sold to an ABCP conduit may signal impending difficulties for the seller.

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

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

*Market risk capital requirements for ABCP programs.* Any facility held in the trading book whose primary function, in form or in substance, is to provide liquidity to ABCP—even if the facility does not qualify as an eligible ABCP liquidity facility under the rule—will be subject to the banking-book risk-based capital requirements. Specifically, banks are required to convert the notional amount of all trading-book positions that provide liquidity to ABCP to credit-equivalent amounts by applying the appropriate banking-book credit-conversion factors. For example, the full amount of all eligible ABCP liquidity facilities with an original maturity of one year or less will be subject to a

10 percent conversion factor, regardless of whether the facility is carried in the trading account or the banking book.

## SOUND RISK-MANAGEMENT PRACTICES

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

### Board and Senior Management Oversight

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

### Policies and Procedures

Senior management is responsible for ensuring that the risks arising from securitization activities are adequately managed on both a short-term and long-run basis. Management should

<sup>19a</sup>. See 12 CFR 208, appendix A, section III.B.3.b.i.



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

commensurate with the complexity and volume of their securitizations and their overall risk exposures. The risk-management function should ensure that securitization policies and operating procedures, including clearly articulated risk limits, are in place and appropriate for the institution's circumstances. A sound asset-

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

## Independent Risk-Management Function

Institutions engaged in securitizations need to have an independent risk-management function

securitization policy should include or address, at a minimum—

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

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

### *Risk Measurement and Monitoring*

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

activities should also be included in any aggregations of credit risk by borrower, industry, or economic sector.

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

### *Stress Testing*

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

### *Internal Controls*

One of management's most important responsibilities is establishing and maintaining an effective system of internal controls. Among other things, internal controls should enforce the official lines of authority and the appropriate separation of duties in managing the risks of the institution. These internal controls must be suitable for the type and level of risks at the institution, given the nature and scope of its

activities. Moreover, these internal controls should ensure that financial reporting is reliable (in published financial reports and regulatory reports), including adequate allowances or liabilities for expected losses.

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

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

### *Audit Function or Internal Review*

The institution's board of directors is responsible for ensuring that its audit staff or independent-review function is competent to review its securitization activities. The audit function should perform periodic reviews of securitization activities, including transaction testing and verification, and report all findings to the board or appropriate board committee. The audit function also may be useful to senior management in identifying and measuring risk related to securitization activities. Principal audit targets should include compliance with securitization policies, operating and accounting

procedures (FAS 140), deal covenants, and the accuracy of MIS and regulatory reports. The audit function also should confirm that the institution's regulatory reporting process is designed and managed to facilitate timely and accurate report filing. Furthermore, when a third party services loans, the auditors should perform an independent verification of the existence of the loans to ensure that balances reconcile to internal records.

### Management Information Systems

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

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

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

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

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

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

### Securitization Covenants Linked to Supervisory Actions or Thresholds

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

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

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

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

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

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

Examiners should consider the potential impact of such covenants in existing transactions when evaluating both the overall condition of the bank and the specific component ratings of capital, liquidity, and management. Early-

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

## APPRAISALS AND MORTGAGE-BACKED SECURITIES

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

## EXAMINATION GUIDELINES FOR ASSET SECURITIZATION

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

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

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

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

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

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

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

risk, liquidity risk, and concentration risk; the underlying assets and structure of the securitization arrangement would be evaluated only within this context.

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

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

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

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

### Banking Organizations Involved in Issuing or Managing ABS

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

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

Analysis of the underlying assets should be conducted independently by each participant in the process, giving consideration to yield,

maturity, credit risk, prepayment risk, and the accessibility of collateral in cases of default. An originator should further consider the impact of securitization on the remaining asset portfolio and on the adequacy of loan-loss reserves and overall capital.

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

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

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

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

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

## *Policy and Portfolio Analysis*

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

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

In addition to recourse obligations, institutions assume concentrated credit risk through the extension of partial direct-credit substitutes, such as through the purchase (or retention) of subordinated interests in their own asset securitizations or through the extension of letters of credit. For example, BOs that sponsor certain asset-backed commercial paper programs, or so-called remote-origination conduits, can be exposed to high degrees of credit risk even though it may seem that their notional exposure is minimal. A remote-origination conduit lends directly to corporate customers referred to it by the sponsoring BO that used to lend directly to these same borrowers. The conduit funds this

lending activity by issuing commercial paper that, in turn, is guaranteed by the sponsoring BO. The net result is that the sponsoring institution has much the same credit-risk exposure through this guarantee that it would have had if it had made the loans directly and held them on its books. This is an off-balance-sheet transaction, however, and its associated risks may not be fully reflected in the institution's risk-management system.

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

The structure of various securitization transactions can also result in an institution's retaining the underlying credit risk in a sold pool of assets. Examples of this contingent credit-risk retention include credit card securitizations in which the securitizing organization explicitly sells the credit card receivables to a master trust, but, in substance, retains the majority of the economic risk of loss associated with the assets because of the credit protection provided to

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

investors by the excess yield, spread accounts, and structural provisions of the securitization. Excess yield provides the first level of credit protection that can be drawn upon to cover cash shortfalls between the principal and coupon owed to investors and the investors' pro rata share of the master trust's net cash flows. The excess yield is equal to the difference between the overall yield on the underlying credit card portfolio and the master trust's operating expenses.<sup>26</sup> The second level of credit protection is provided by the spread account, which is essentially a reserve funded initially from the excess yield.

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

Examiner procedures for reviewing credit risk are outlined below:

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

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



writer must perform assessments and approvals independent of and distinct from reviews provided by the originator or packager.

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

- Pricing policies and practices should be reviewed to determine that they incorporate an analysis of the tradeoff between risk and return.
- Examiners should consider securitization risks when analyzing the adequacy of an organization's capital or reserve levels. Adverse credit risk should be classified accordingly.

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

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

*Reputational risk.* The securitization activities of many institutions may also expose them to significant reputational risks. Often, BOs that sponsor the issuance of asset-backed securities act as servicers, administrators, or liquidity providers in the securitization transactions. These institutions must be aware of the potential losses and risk exposure associated with reputational risk that arise from these securitization activities. The securitization of assets whose perfor-

mance has deteriorated may result in a negative market reaction that could increase the spreads on an institution's subsequent issuances. To avoid a possible increase in their funding costs, institutions have supported their securitization transactions by improving the performance of the securitized asset pool (for example, by selling discounted receivables or adding higher-quality assets to the securitized asset pool). Thus, an institution's voluntary support of its securitization in order to protect its reputation can adversely affect the sponsoring or issuing organization's earnings and capital.

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

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

- Examiners should review the policies of a BO engaged in underwriting, looking for situations in which it cannot sell underwritten ABS. Credit review, funding capabilities, and approval limits should allow the institution to

purchase and hold unsold securities. In the absence of this analysis, the institution should only handle ABS on a best-efforts basis. All potential credit exposure should be within legal lending limits.

- Examiners should ensure that a BO engaged in underwriting or market making has implemented adequate hedging or other risk-management policies to limit its exposure to adverse price movements.
- Examiners should determine whether an organization targets certain loans at origination to be packaged and securitized. If so, examiners should review the length of time these assets are held while being processed. Examiners should review management information systems reports to age targeted loans and to determine if there is any decline in value while the loans are in the pipeline. Loans held for resale in this pipeline should be segregated and carried at the lower of cost or market value.

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

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

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

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

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

### *Legal Review and Liability*

The complexity of asset-securitization transac-

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

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

### **Banking Organizations Investing in ABS**

ABS may appear similar to corporate notes; however, ABS possess many unique characteristics that affect their riskiness as investments. A BO should independently analyze all potential risk exposures before investing in ABS and should continue to monitor exposures throughout the life of the ABS. Analyses should focus

primarily on characteristics of ABS, such as credit risk, concentrations of exposures, interest-rate risk, liquidity risk, market risk, and prepayment risk. As an integral part of these analyses, a BO investing in ABS should evaluate the underlying assets, the participants in the securitization arrangement, and the structure of the securitization arrangement, although it should not be expected to analyze these factors in the same detail as BOs involved in the issuance of ABS.

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

### *Policy and Portfolio Analysis*

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

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

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

- Examiners should review a BO's policies and procedures to ensure that the organization follows prudent standards of credit assessment

and has approval criteria for all ABS exposure. Procedures should include an initial thorough and independent credit assessment of ABS issues for which the organization has assumed any degree of credit risk, followed by periodic reviews to monitor performance of the ABS throughout the life of the exposure.

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

*Concentration risk.* Banking organizations may face concentrations of risk within the pool of assets, underlying an individual ABS issue, across different ABS issues, or through combinations of ABS and other credit exposures. Banking organizations that invest in ABS must

take special care to follow in-house diversification requirements for aggregate outstandings to a particular institution, industry, or geographic area. Examiner procedures for reviewing concentration risk are outlined below:

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

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

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

information on the historical costs, market values, and unrealized gains and losses on ABS held in investment, trading, or resale portfolios.

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

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

### *Legal Review*

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

### **Internal Audit and Management Information Systems**

A BO's management of securitization risk depends on the providing of timely and accurate information about the organization's exposure to those responsible for monitoring risks. Examiners must be aware that a BO's involvement in asset securitization can be very extensive and place significant demands on systems without being readily evident, either as an on-balance-sheet exposure or a contingent liability. System overload or other technical default in the organization's systems could render the organization unable to provide proper monitoring or servicing. While the risk is not clearly associated with

the servicer (whose responsibility is long term and requires ongoing resource commitments), systems breakdowns may have risk implications for the credit enhancer and trustee. Examiners should ensure that internal auditors examine all facets of securitization regularly, as outlined below:

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

## ADDITIONAL REFERENCES

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

### FASB Statements

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

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

## FASB Interpretations

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

## Technical Bulletins

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

## EITF (Emerging Issues Task Force) Abstracts

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

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

### AICPA Statements of Position

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



# Asset Securitization

## Examination Objectives

Effective date November 2004

## Section 4030.2

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

# Asset Securitization Examination Procedures

Effective date April 2011

## Section 4030.3

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

- determining compliance with internal credit-exposure limits.
12. Review the bank's valuation assumptions and modeling methodology used for ABS to determine if they are conservative and appropriate and are being used to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis.
  13. Determine if audit or internal-review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets that the institution retains.
  14. Review the risk-based capital calculations, and determine if they include recognition and the correct reporting of any recourse obligations, direct-credit substitutes, residual interests, asset- and mortgage-backed securities, asset-backed commercial paper (ABCP) programs, liquidity facilities, and other transactions involving such securitization activities.
  15. Determine if the bank consolidates, in accordance with GAAP (FASB's Statement of Financial Accounting Standards No. 167, "Amendments to FASB Interpretation No. 146(R)(FAS 167)" the assets of any ABCP program or other such program that it sponsors.
    - a. Determine if the bank's ABCP program met the definition of a sponsored ABCP program under the risk-based capital guidelines.
    - b. Ascertain whether the liquidity facilities the bank extends to the ABCP program satisfy the risk-based capital definition and requirements, including the appropriate asset-quality test, of an eligible ABCP program liquidity facility. (See 12 CFR 208, appendix A, III.B.3.a.iv.)
    - c. Determine whether the bank applied the correct credit-conversion factor to eligible ABCP liquidity facilities when it determined the amount of risk-weighted assets for its risk-based capital ratios. (See 12 CFR 208, appendix A, section III.D.)
    - d. Determine if all ineligible ABCP liquidity facilities were treated as either direct-credit substitutes or as recourse obligations, as required by the risk-based capital guidelines.
    - e. If the bank had multiple positions with overlapping exposures, determine if the bank applied the risk-based capital treatment that resulted in the highest capital charge. (See 12 CFR, appendix A, section III.B.6.c.)
  16. Ascertain that internal limits govern the amount of retained interests held as a percentage of total equity capital.
  17. Establish that an adequate liquidity contingency plan is in place and will be used in the event of market disruptions. Determine whether liquidity problems may arise as the result of an overdependence on asset-securitization activities for day-to-day core funding.
  18. Determine whether consistent, conservative accounting practices are in place that satisfy the reporting requirements of regulatory supervisors, GAAP reporting requirements, and valuation assumptions and methods. Ascertain that adequate disclosures of asset-securitization activities are made commensurate with the volume of securitizations and the complexities of the institution.
  19. Establish that risk-exposure limits and requirements exist and are adhered to on an aggregate and individual transaction basis.
  20. Review securitized assets for industrial or geographic concentrations. Excessive exposures to an industry or region among the underlying assets should be noted in the review of the loan portfolio.
  21. Ensure that, in addition to policies limiting direct credit exposure, an institution has developed exposure limits for particular originators, credit enhancers, trustees, and servicers.
  22. Review the policies of the banking organization engaged in underwriting, watching for situations in which it cannot sell underwritten asset-backed securities. Credit review, funding capabilities, and approval limits should allow the institution to purchase and hold unsold securities. All potential credit exposure should be within legal lending limits.
  23. Ensure that internal systems and controls adequately track the performance and condition of internal exposures and monitor the organization's compliance with internal procedures and limits. In addition, adequate audit trails and internal audit coverage should be provided. Ensure that the reports have adequate scope and frequency of detail.

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

# Asset Securitization

## Internal Control Questionnaire

Effective date November 2004

## Section 4030.4

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

### POLICIES

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

- price movements when it is engaged in underwriting or market-making activities?
3. Are the bank's securitization policies reviewed and reaffirmed at least annually to determine if they are compatible with changing market conditions?

### INTERNAL CONTROL AND MANAGEMENT INFORMATION SYSTEMS

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

(including exposures arising from direct-credit substitutes, recourse obligations, residual interests, liquidity facilities, and

mortgage-backed and other types of asset-backed loans)?

# Elevated-Risk Complex Structured Finance Activities

Effective date October 2007

## Section 4033.1

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

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

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

When a financial institution<sup>3</sup> participates in a

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

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

### Scope and Purpose of Statement

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

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

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

3. As used in this statement, the term *financial institution* or *institution* refers to state member banks and bank holding companies (other than foreign banking organizations) in the

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

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

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

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

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

Because many of the core elements of an effective control infrastructure are the same regardless of the business line involved, this statement draws heavily on controls and procedures that the agencies previously have found to be effective in assisting a financial institution to manage and control risks and identifies ways in which these controls and procedures can be effectively applied to elevated-risk CSFTs. Although this statement highlights some of the most significant risks associated with elevated-risk CSFTs, it is not intended to present a full exposition of all risks associated with these transactions. Financial institutions are encouraged to refer to other supervisory guidance prepared by the agencies for further information

concerning market, credit, operational, legal, and reputational risks as well as internal audit and other appropriate internal controls.

This statement does not create any private rights of action and does not alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders, or other third parties under applicable law. At the same time, adherence to the principles discussed in this statement would not necessarily insulate a financial institution from regulatory action or any liability the institution may have to third parties under applicable law.

## Identification and Review of Elevated-Risk CSFTs

A financial institution that engages in CSFTs should maintain a set of formal, written, firm-wide policies and procedures that are designed to allow the institution to identify, evaluate, assess, document, and control the full range of credit, market, operational, legal, and reputational risks associated with these transactions. These policies may be developed specifically for CSFTs, or included in the set of broader policies governing the institution generally. A financial institution operating in foreign jurisdictions may tailor its policies and procedures as appropriate to account for, and comply with, the applicable laws, regulations, and standards of those jurisdictions.<sup>5</sup>

A financial institution's policies and procedures should establish a clear framework for the review and approval of individual CSFTs. These policies and procedures should set forth the responsibilities of the personnel involved in the origination, structuring, trading, review, approval, documentation, verification, and execution of CSFTs. Financial institutions may find it helpful to incorporate the review of new CSFTs into their existing new-product policies. In this regard, a financial institution should define what constitutes a "new" complex structured finance product and establish a control process for the approval of such new products. In determining

5. In the case of U.S. branches and agencies of foreign banks, these policies, including management, review, and approval requirements, should be coordinated with the foreign bank's group-wide policies developed in accordance with the rules of the foreign bank's home-country supervisor and should be consistent with the foreign bank's overall corporate and management structure as well as its framework for risk management and internal controls.



whether a CSFT is new, a financial institution may consider a variety of factors, including whether it contains structural or pricing variations from existing products; whether the product is targeted at a new class of customers; whether it is designed to address a new need of customers; whether it raises significant new legal, compliance, or regulatory issues; and whether it or the manner in which it would be offered would materially deviate from standard market practices. An institution's policies should require new complex structured finance products to receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.

## Identifying Elevated-Risk CSFTs

As part of its transaction and new-product approval controls, a financial institution should establish and maintain policies, procedures, and systems to identify elevated-risk CSFTs. Because of the potential risks they present to the institution, transactions or new products identified as elevated-risk CSFTs should be subject to heightened reviews during the institution's transaction or new-product approval processes. Examples of transactions that an institution may determine warrant this additional scrutiny are those that (either individually or collectively) appear to the institution during the ordinary course of its transaction approval or new-product approval process to—

- lack economic substance or business purpose;
- be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year-end or at the end of a reporting period for the customer;
- raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements;
- involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose;
- involve oral or undocumented agreements that, when taken into account, would have a

material impact on the regulatory, tax, or accounting treatment of the related transaction, or the client's disclosure obligations;<sup>6</sup>

- have material economic terms that are inconsistent with market norms (for example, deep "in the money" options or historic rate rollovers); or
- provide the financial institution with compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market, or operational risk assumed by the institution.

The examples listed previously are provided for illustrative purposes only, and the policies and procedures established by financial institutions may differ in how they seek to identify elevated-risk CSFTs. The goal of each institution's policies and procedures, however, should remain the same: to identify those CSFTs that warrant additional scrutiny in the transaction or new-product approval process due to concerns regarding legal or reputational risks.

Financial institutions that structure or market, act as an advisor to a customer regarding, or otherwise play a substantial role in a transaction may have more information concerning the customer's business purpose for the transaction and any special accounting, tax, or financial disclosure issues raised by the transaction than institutions that play a more limited role. Thus, the ability of a financial institution to identify the risks associated with an elevated-risk CSFT may differ depending on its role.

### *Due Diligence, Approval, and Documentation Process for Elevated-Risk CSFTs*

Having developed a process to identify elevated-risk CSFTs, a financial institution should implement policies and procedures to conduct a heightened level of due diligence for these transactions. The financial institution should design these policies and procedures to allow personnel at an appropriate level to understand and evaluate the potential legal or reputational risks presented by

6. This item is not intended to include traditional, nonbinding "comfort" letters or assurances provided to financial institutions in the loan process where, for example, the parent of a loan customer states that the customer (i.e., the parent's subsidiary) is an integral and important part of the parent's operations.

the transaction to the institution and to manage and address any heightened legal or reputational risks ultimately found to exist with the transaction.

*Due diligence.* If a CSFT is identified as an elevated-risk CSFT, the institution should carefully evaluate and take appropriate steps to address the risks presented by the transaction, with a particular focus on those issues identified as potentially creating heightened levels of legal or reputational risk for the institution. In general, a financial institution should conduct the level and amount of due diligence for an elevated-risk CSFT that is commensurate with the level of risks identified. A financial institution that structures or markets an elevated-risk CSFT to a customer, or that acts as an advisor to a customer or investors concerning an elevated-risk CSFT, may have additional responsibilities under the federal securities laws, the Internal Revenue Code, state fiduciary laws, or other laws or regulations and, thus, may have greater legal- and reputational-risk exposure with respect to an elevated-risk CSFT than a financial institution that acts only as a counterparty for the transaction. Accordingly, a financial institution may need to exercise a higher degree of care in conducting its due diligence when the institution structures or markets an elevated-risk CSFT or acts as an advisor concerning such a transaction than when the institution plays a more limited role in the transaction.

To appropriately understand and evaluate the potential legal and reputational risks associated with an elevated-risk CSFT that a financial institution has identified, the institution may find it useful or necessary to obtain additional information from the customer or to obtain specialized advice from qualified in-house or outside accounting, tax, legal, or other professionals. As with any transaction, an institution should obtain satisfactory responses to its material questions and concerns prior to consummation of a transaction.<sup>7</sup>

In conducting its due diligence for an elevated-risk CSFT, a financial institution should independently analyze the potential risks to the institution from both the transaction and the institution's overall relationship with the customer. Institutions should not conclude that a transaction identified as being an elevated-risk

CSFT involves minimal or manageable risks solely because another financial institution will participate in the transaction or because of the size or sophistication of the customer or counterparty. Moreover, a financial institution should carefully consider whether it would be appropriate to rely on opinions or analyses prepared by or for the customer concerning any significant accounting, tax, or legal issues associated with an elevated-risk CSFT.

*Approval process.* A financial institution's policies and procedures should provide that CSFTs identified as having elevated legal or reputational risk are reviewed and approved by appropriate levels of control and management personnel. The designated approval process for such CSFTs should include representatives from the relevant business line(s) and/or client management, as well as from appropriate control areas that are independent of the business line(s) involved in the transaction. The personnel responsible for approving an elevated-risk CSFT on behalf of a financial institution should have sufficient experience, training, and stature within the organization to evaluate the legal and reputational risks, as well as the credit, market, and operational risks to the institution.

The institution's control framework should have procedures to deliver the necessary or appropriate information to the personnel responsible for reviewing or approving an elevated-risk CSFT to allow them to properly perform their duties. Such information may include, for example, the material terms of the transaction, a summary of the institution's relationship with the customer, and a discussion of the significant legal, reputational, credit, market, and operational risks presented by the transaction.

Some institutions have established a senior management committee that is designed to involve experienced business executives and senior representatives from all of the relevant control functions within the financial institution (including such groups as independent risk management, tax, accounting, policy, legal, compliance, and financial control) in the oversight and approval of those elevated-risk CSFTs that are identified by the institution's personnel as requiring senior management review and approval due to the potential risks associated with the transactions. While this type of management committee may not be appropriate for all financial institutions, a financial institution should establish processes that assist the institution in con-

7. Of course, financial institutions also should ensure that their own accounting for transactions complies with applicable accounting standards, consistently applied.

sistently managing the review and approval of elevated-risk CSFTs on a firm-wide basis.<sup>8</sup>

If, after evaluating an elevated-risk CSFT, the financial institution determines that its participation in the CSFT would create significant legal or reputational risks for the institution, the institution should take appropriate steps to address those risks. Such actions may include declining to participate in the transaction, or conditioning its participation upon the receipt of representations or assurances from the customer that reasonably address the heightened legal or reputational risks presented by the transaction. Any representations or assurances provided by a customer should be obtained before a transaction is executed and be received from, or approved by, an appropriate level of the customer's management. A financial institution should decline to participate in an elevated-risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risk to the institution or would result in a violation of applicable laws, regulations, or accounting principles.

*Documentation.* The documentation that financial institutions use to support CSFTs is often highly customized for individual transactions and negotiated with the customer. Careful generation, collection, and retention of documents associated with elevated-risk CSFTs are important control mechanisms that may help an institution monitor and manage the legal, reputational, operational, market, and credit risks associated with the transactions. In addition, sound documentation practices may help reduce unwarranted exposure to the financial institution's reputation.

A financial institution should create and collect sufficient documentation to allow the institution to—

- document the material terms of the transaction;
- enforce the material obligations of the counterparties;
- confirm that the institution has provided the customer any disclosures concerning the trans-

action that the institution is otherwise required to provide; and

- verify that the institution's policies and procedures are being followed and allow the internal audit function to monitor compliance with those policies and procedures.

When an institution's policies and procedures require an elevated-risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation, such as minutes of the relevant senior management committee, that reflect senior management's approval (or disapproval) of the transaction, any conditions imposed by senior management, and the factors considered in taking such action. The institution should retain documents created for elevated-risk CSFTs in accordance with its record retention policies and procedures as well as applicable statutes and regulations.

#### *Other Risk-Management Principles for Elevated-Risk CSFTs*

*General business ethics.* The board and senior management of a financial institution also should establish a "tone at the top" through both actions and formalized policies that sends a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics. The board and senior management should strive to create a firm-wide corporate culture that is sensitive to ethical or legal issues as well as the potential risks to the financial institution that may arise from unethical or illegal behavior. This kind of culture coupled with appropriate procedures should reinforce business-line ownership of risk identification and encourage personnel to move ethical or legal concerns regarding elevated-risk CSFTs to appropriate levels of management. In appropriate circumstances, financial institutions may also need to consider implementing mechanisms to protect personnel by permitting the confidential disclosure of concerns.<sup>9</sup> As in other areas of financial institution

8. The control processes that a financial institution establishes for CSFTs should take account of, and be consistent with, any informational barriers established by the institution to manage potential conflicts of interest, insider trading, or other concerns.

9. The agencies note that the Sarbanes-Oxley Act of 2002 requires companies listed on a national securities exchange or inter-dealer quotation system of a national securities association to establish procedures that enable employees to submit

management, compensation and incentive plans should be structured, in the context of elevated-risk CSFTs, so that they provide personnel with appropriate incentives to have due regard for the legal-, ethical-, and reputational-risk interests of the institution.

*Reporting.* A financial institution's policies and procedures should provide for the appropriate levels of management and the board of directors to receive sufficient information and reports concerning the institution's elevated-risk CSFTs to perform their oversight functions.

*Monitoring compliance with internal policies and procedures.* The events of recent years evidence the need for an effective oversight and review program for elevated-risk CSFTs. A financial institution's program should provide for periodic independent reviews of its CSFT activities to verify and monitor that its policies and controls relating to elevated-risk CSFTs are being implemented effectively and that elevated-risk CSFTs are accurately identified and have received proper approvals. These independent reviews should be performed by appropriately qualified audit, compliance, or other personnel in a manner consistent with the institution's overall framework for compliance monitoring, which should include consideration of issues such as the independence of reviewing personnel from the business line. Such monitoring may include more-frequent assessments of the risk arising from elevated-risk CSFTs, both individually and within the context of the overall customer relationship, and the results of this monitoring should be provided to an appropriate level of management in the financial institution.

*Audit.* The internal audit department of any financial institution is integral to its defense against fraud, unauthorized risk taking, and damage to the financial institution's reputation. The internal audit department of a financial institution should regularly audit the financial institution's adherence to its own control procedures relating to elevated-risk CSFTs, and further assess the adequacy of its policies and

procedures related to elevated-risk CSFTs. Internal audit should periodically validate that business lines and individual employees are complying with the financial institution's standards for elevated-risk CSFTs and appropriately identifying any exceptions. This validation should include transaction testing for elevated-risk CSFTs.

*Training.* An institution should identify relevant personnel who may need specialized training regarding CSFTs to be able to effectively perform their oversight and review responsibilities. Appropriate training on the financial institution's policies and procedures for handling elevated-risk CSFTs is critical. Financial institution personnel involved in CSFTs should be familiar with the institution's policies and procedures concerning elevated-risk CSFTs, including the processes established by the institution for identification and approval of elevated-risk CSFTs and new complex structured finance products and for the elevation of concerns regarding transactions or products to appropriate levels of management. Financial institution personnel involved in CSFTs should be trained to identify and properly handle elevated-risk CSFTs that may result in a violation of law.

## CONCLUSION

Structured finance products have become an essential and important part of the U.S. and international capital markets, and financial institutions have played an important role in the development of structured finance markets. In some instances, however, CSFTs have been used to misrepresent a customer's financial condition to investors and others, and financial institutions involved in these transactions have sustained significant legal and reputational harm. In light of the potential legal and reputational risks associated with CSFTs, a financial institution should have effective risk-management and internal control systems that are designed to allow the institution to identify elevated-risk CSFTs; to evaluate, manage, and address the risks arising from such transactions; and to conduct those activities in compliance with applicable law.

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concerns regarding questionable accounting or auditing matters on a confidential, anonymous basis. (See 15 USC 78j-1(m).)

Bank management is responsible for controlling risk at a level deemed acceptable for the organization. An effective risk-management program begins with the identification of exposures that could disrupt the timely and accurate delivery of business services or result in unexpected financial claims on bank resources. Risk management also involves the implementation of cost-effective controls and the shifting, transfer, or assignment of risk to third parties through insurance coverage or other risk-transfer techniques. Although the design and sophistication of risk-management procedures varies from bank to bank, each institution's decision-making process should effectively identify; control; and, when or where appropriate, result in some transfer of risk. The risk-assessment program should be conducted annually to establish whether potential service disruptions and estimated risk-related financial costs and losses can be contained at levels deemed acceptable to bank management and the board of directors. Note that insurance can provide a bank with the resources to restore business operations and financial stability only *after* an unanticipated event has occurred, but a bank's own risk-management controls can prevent and minimize losses before they occur.

### RISK-MANAGEMENT PROGRAM

A sound operational risk-management program requires the annual review of all existing business operations and a risk assessment of all proposed services. Identified risks should be analyzed to estimate their potential and probable levels of loss exposure. While the historical loss experience of the bank and other service providers may be helpful in quantifying loss exposure, technological and societal changes may result in exposure levels that differ from historical experience. Nevertheless, current exposure estimates should be derived from the bank's historical loss experience and augmented with industry experience. In addition, the bank's insurance broker or agent should be a source of advice.

Management must decide the most appropriate method for addressing a particular risk. Although many factors influence this decision, the purpose of risk management is to minimize

the probability of losses and the net costs associated with them. In that context, cost is broadly defined to include—

- the direct and consequential cost of loss-prevention measures (controls), plus
- insurance premiums, plus
- losses sustained, including the consequential effects and expenses to reduce such losses, minus
- recoveries from third parties and indemnities from insurers on account of such losses, plus
- pertinent administrative costs.

Bank risks with potentially high or even catastrophic financial consequences should be eliminated or substantially mitigated whenever possible, even when the risk's frequency of occurrence is low. These risks can be eliminated by discontinuing operations where appropriate or by assigning the risk exposure to other parties using third-party service providers. When the exposure cannot be shifted to other parties or otherwise mitigated, the bank must protect itself with appropriate levels of insurance. Certain loss exposures may be deemed reasonable because their probability of frequency and severity of loss are low, the level of expected financial loss or service disruption is minimal, or the costs associated with the recovery of assets and restoration of services are low.

Bank management may decide to reduce insurance premiums and claims-processing costs by self-insuring for various types of losses, setting higher deductible levels, lowering the coverage limits for insurance purchased, and narrowing coverage terms and conditions. A financial organization's primary defenses against loss are adequate internal controls and procedures, which insurance is intended to complement, not replace. Thus, an overall appraisal of the organization's control environment is a significant consideration in determining the adequacy of the insurance program. To the extent that controls are lacking, the need for additional insurance coverage increases. These determinations should be based on the results of the risk assessment and be consistent with the limits established by the board of directors. Insurance decisions may also be influenced by the insurance broker's advice regarding current insurance market and premium trends.



Following September 2001, insurance companies reevaluated their position on providing coverage for acts of terrorism. As a result, terrorism coverage has become expensive or unavailable. The bank's "schedule of insurance" should note which policies contain exclusions, sublimits, or large deductibles for losses incurred as a result of terrorism.

When selecting insurance carriers, banks should consider the financial strength and claims-paying capacity of the insurance underwriter, as well as the robustness or strength of the supervisory regime to which the insurer is subject. This procedure is important for all significant policy-coverage lines. Rating agencies typically consider a number of insurers vulnerable, and some underwriters may have large environmental exposures but capped equity resources. Many large commercial enterprises acquire insurance coverage from foreign companies or from subsidiaries of U.S. insurers domiciled in the Caribbean or other countries. The quality of insurance supervision in many foreign countries may not meet the standards expected in the United States.

## TYPES OF RISKS

Business risks generally fall into three categories: (1) physical property damage, (2) liability resulting from product failure or unintended employee performance, and (3) loss of key personnel. Common property risks are fires or natural disasters such as storms and earthquakes, but acts of violence or terrorism can also be included in this category. Risk-management programs for property damage should consider not only the protection and replacement of the physical plant, but also the effects of business interruptions, loss of business assets, and reconstruction of records.

Insurance programs increasingly cover the consequences of the second category, product failure or unintended employee performance. These risks include the injury or death of employees, customers, and others; official misconduct; and individual and class-action lawsuits alleging mistreatment or the violation of laws or regulations. All aspects of a bank's operation are susceptible to liability risks. While property-loss levels can be estimated with relative confidence, jury awards for personal injury or product liability, and the related litigation

costs, often exceed expectations. In addition, it can be difficult to identify potential sources of liability exposure.

The third category, personnel risk, concerns those exposures associated with the loss of key personnel through death, disability, retirement, or resignation, as well as threats to all employees and third parties arising out of crimes such as armed robbery and extortion. The consequences of personnel loss are often more pronounced in small and medium-sized banks that do not have the financial resources to support a broad level of management.

## INSURANCE PROGRAM

### Program Objectives

A bank's insurance program should match the objectives of its management, the director-approved risk guidelines, and its individual risk profile. Insurance is primarily the transfer of the financial effect of losses and should be considered as only a part of the broader risk-management process. In that sense, it is imperative that management understands the costs and benefits of the bank's insurance program.

Due to the fluid nature of the insurance market and insurance products, there is no standard program or contract structure. Rather, many different insurance policies, coverages, endorsements, limits, deductibles, and payment plans fit together to form an insurance program. Based on the size and scope of a bank's operations, broader or narrower coverage, higher or lower limits, and separate policies may be purchased. Insurance programs should be customized to the risks that each bank faces. If a bank is particularly susceptible to a specific risk, purchasing additional insurance for that risk may be prudent.

A policy's deductible size and coverages, and the limits purchased, determine how much risk the bank has retained. Likewise, the payment plan of an insurance policy greatly influences the amount of risk transferred. An insurance policy alone does not represent significant risk transfer if the payment plan includes reimbursement to the insurance company for all losses, usually subject to a maximum. These reimburse-

ment, loss-sensitive, or retrospectively rated plans can be viewed more as a risk-financing tool than as risk transfer. Management should understand and quantify the total “all-in” cost of these plans, as well as how these costs correspond with the risk guidelines approved by the directors.

## Common Insurance-Policy Components and Concepts

There is a difference between “policy” and “coverage,” but the two terms are often used interchangeably. The term “policy” usually refers to the actual insurance contract, while the term “coverage” refers to the types of risks to which the policy is designed to respond. For example, a directors’ and officers’ policy may include employment-practices liability (EPL) coverage. However, the bank may also purchase a separate EPL policy.

An “endorsement” is a modification to a policy. Endorsements can be either a simple change in wording from the original contract or a more complex addition or deletion of a coverage section. To expand on the example above, EPL coverage is often endorsed onto a directors’ and officers’ policy. When an endorsement adds a coverage to a policy, it is often called a “rider.”

The “limit of insurance” is the dollar amount of insurance protection purchased. Each policy has a different limit, and some may have separate limits for separate coverages provided under the same policy. Policies usually include a “per-occurrence” and an “aggregate” limit. The per-occurrence limit is the most the insurer will pay under the policy for any one insured event, while the policy aggregate is the most the insurer will pay in total, regardless of the number and size of insurable events.

“Deductibles” and “self-insured retentions (SIRs)” are the dollar amounts the bank must contribute to the loss before insurance applies.<sup>1</sup> They are effectively the same concept, with the difference being a deductible reduces the limits of insurance while a SIR does not. A deductible is included within or as part of the limits. A SIR is outside or in addition to the provided limits. For example, a \$5 million policy limit with a \$1 million deductible consists of \$4 million of

protection and the \$1 million deductible. A \$5 million policy limit with a \$1 million SIR provides \$5 million in protection after the \$1 million dollar SIR is paid by the bank. As in any clause of an insurance contract, the terms can be negotiated so a deductible does not reduce the limits.

“Occurrence” and “claims made” are two separate types of coverage bases of policies that differ as to the period protected, when claims are recognized, and when the policies are “triggered” or respond. Under an occurrence, or “loss-sustained,” form the amount and type of coverage (if any) for the loss event is based on the policy that was in force when the event took place or occurred, regardless of when a claim is submitted. Under a claims-made, or “discovery,” policy, the insurance policy in force when the loss event was discovered and reported to the insurance company would apply, regardless of when the event causing the claim occurred. Both types of policies have provisions regarding prompt claims-reporting to insurers. However, claims-made policies are usually stricter and their coverage may be compromised by failing to report claims in a timely manner.

## Self-Insurance or Alternative Risk Transfer

There are numerous nontraditional insurance programs that larger, more complex banking organizations employ. These programs include, but are not limited to, captive insurance companies, individual or group self-insurance, risk-retention groups, and purchasing groups. These alternative risk-transfer (ART) programs are complex, and they should include common bank policies and procedures. For example, the bank should have access to individuals with insurance expertise. Outside consultants, qualified insurance brokers, and bank directors or management with insurance expertise are an integral part of a successful ART program. The ART program should also incorporate stop-loss provisions and reinsurance coverage to cap the organization’s exposure to severe claims or unexpected loss experience.

## COMMON POLICIES AND COVERAGES

The following is not intended to be a compre-

1. An organization can maintain an unfunded reserve for loss-retention purposes.

hensive list of policies and coverages available, but rather a listing and description of those that banks most frequently purchase. The list is divided into three general types of insurance: liability, property, and life insurance. A fourth category is included for aircraft and aviation insurance, which consists of various types of property and liability coverage. While this last coverage category may be unnecessary for most banking organizations, for those institutions that do have exposure to risks associated with aircraft ownership, the risks may be exceptionally large.

## Fidelity Insurance Bond

Liability insurance is sometimes called “third-party insurance” because three parties are involved in a liability loss: the insured, the insurance company, and the party (the claimant) who is injured or whose property is damaged by the insured. The insurance company pays the claimant on behalf of the insured if the insured is legally liable for the injury or damage. An insured’s legal liability for injury is often the result of a negligent act, but there are other sources of liability. Several examples of liability insurance are discussed below.

Fidelity bond coverage provides reimbursement for loss from employee dishonesty; robbery; burglary; theft; forgery; mysterious disappearance; and, in specified instances, damage to offices or fixtures of the insured. Coverage applies to all banking locations except automated teller machines, for which coverage must be specifically added. All banks should obtain fidelity bond coverage that is appropriate for their business needs.

The most widely used form of fidelity bond is the Financial Institution Bond (FIB), Standard Form No. 24 (formerly named the bankers’ blanket bond). Standard Form No. 24 is a claims-made, or discovery, form. The “basic” FIB has four insuring agreements or parts. Employee Dishonesty/Fidelity (Clause A) covers dishonest or fraudulent acts committed by employees. On-Premises (Clause B) covers losses from burglary, misplacement, or an unexplained disappearance that occurs on premises. In-Transit (Clause C) covers losses from burglary, misplacement, or an unexplained disappearance that occurs while the property is in transit. Counterfeit Currency (Clause F) covers losses from accepting counterfeit currency.

In addition to the basic four FIB insuring agreements, Forgery or Alteration (Clause D) and Securities (Clause E) may also appear on the standard form. (These coverages may not be a component of the most basic insurance program for a small bank.) Significant enhancements and additional coverages are often endorsed onto the FIB. Any misrepresentation, omission, concealment, or incorrect statement of material fact in the insurance application is grounds for rescission of the fidelity bond by the underwriting insurance company.

When the bank under examination is a subsidiary of a bank holding company, and the holding company has purchased one fidelity bond to cover all affiliated banks, the examiner should determine that the policy is sufficient to cover the exposures of the subsidiary bank being examined. Examiners also should determine that any policy premiums the subsidiary bank pays to the parent holding company are not disproportionate to the bank’s benefits from the group policy and that such premiums are consistent with the fair-market requirements of section 23B of the Federal Reserve Act. Split-limit coverage may reduce protection if a loss involves the collusion of subsidiary bank employees or other affiliates of a bank holding company.

### *Clause A: Fidelity (Employee Dishonesty)*

Clause A covers losses resulting directly from dishonest or fraudulent acts an officer or employee commits, either acting alone or in collusion with others. The employee must have had a manifest intent to cause a loss to the financial institution, and the employee or another person or entity must obtain financial benefit from the dishonest or fraudulent act. Officers, attorneys retained by the bank, persons provided by an employment contractor, and nonemployee data processors who are performing services for the insured are typically all considered “employees.” If any of the loss results from loans, that part of the loss is covered only if the employee was in collusion with other parties to the transaction and the employee received a minimum financial-benefit amount, as specified in the policy. (“Financial benefit” does not include any employee benefits earned in the normal course of employment, including salaries, commissions, fees, bonuses, promotions, awards, profit-sharing plans, or pensions.) Clause A should not prevent the recovery of losses from



employee dishonesty that are concealed by fictitious loans.

#### *Clause B: On-Premises*

Clause B covers losses of property (as defined in the bond) that occur on premises as a result of robbery, burglary, larceny, misplacement, theft, or a mysterious and unexplained disappearance. Under specified conditions, damage to offices and equipment may be covered under this clause. However, premises coverage should not be confused with standard fire or other types of property insurance.

#### *Clause C: In-Transit*

Clause C covers loss of property that is in transit. The property typically must be in the custody of (1) a natural person acting as a messenger for the insured, (2) a transportation company transporting the property in an armored motor vehicle, or (3) a transportation company transporting the property by means other than an armored motor vehicle. When an armored vehicle is not used by a transportation company, “property” is generally limited to records, certified securities, and negotiable instruments that are not payable to the bearer, are not endorsed, and have no restrictive endorsements. Some insuring agreements insure certain financial institution employees that carry cash.

#### *Clause D: Forgery or Alteration*

Clause D covers forgery, which is the signing of the name of another person or organization with the intent to deceive. Clause D also covers losses resulting from the alteration of any negotiable instrument. Evidences of debt, which the bank receives either over-the-counter or through clearings, are not usually covered. Fraudulent items received through an electronic funds transfer system are generally excluded.

#### *Clause E: Securities*

Clause E covers losses that result from a bank’s extending credit or assuming liability on the faith of original securities, documents, or written instruments that are forged, altered, lost, or stolen. These include but are not limited to a

certificated security, a title, a deed or mortgage, a certificate of origin or title, an evidence of debt, a security agreement, an instruction to a Federal Reserve Bank, and a statement of uncertificated security of a Federal Reserve Bank. Coverage is included for certain counterfeit securities and instruments. The bank must have acted in good faith and had actual physical possession of the original instrument.

#### *Clause F: Counterfeit Currency*

Clause F provides coverage for losses resulting from the receipt of counterfeit money. The coverage is counterfeit money of the United States, Canada, or any other country where the insured maintains a branch office.

### **Common FIB Extensions, Riders, or Endorsements**

Fidelity bond protection can be extended by purchasing additional coverage through extensions, riders, and endorsements. If a bank has significant risk exposures in certain areas, these additional protections should be considered. The most common of these protections are listed below.

#### *Extortion/Threats to Persons or Property*

The extortion/threats to persons or property rider insures against loss of property that is surrendered away from a banking office as the result of a threat to do bodily harm to a director, trustee, employee, or relative, or of threats to damage banking premises or property. While a bank may add this coverage with a rider to its FIB, many banks purchase a separate, more comprehensive policy or endorse this coverage onto the directors’ and officers’ policy.

#### *Trading Losses*

The trading-loss rider amends the FIB exclusion by providing coverage for trading losses resulting directly from employee dishonesty.

#### *Automated Teller Machines*

The automated teller machine (ATM) rider cov-

ers losses of money from, or damage to, an unattended ATM that results from robbery, burglary, or theft.

### *Electronic or Computer Systems*

The electronic or computer-systems rider covers direct losses caused by fraudulent funds transfers originated through the bank's computer systems. The fraud may be caused by a dishonest employee, customer, or third party.

### *Unauthorized Signatures*

The unauthorized-signature rider covers losses resulting from a bank's acceptance, cashing, or payment of any negotiable instrument or withdrawal order that bears an unauthorized signature. An "unauthorized signature" is not forged, but is the signature of an individual who is not an authorized signatory on the account.

### *Fraudulent Mortgages*

The fraudulent-mortgages rider insures against loan losses that result from a bank's accepting or acting on mortgages or deeds of trust that have defective signatures. "Defective signatures" are those obtained through fraud or trickery or under false pretenses.

### *Counterfeit Checks*

The counterfeit-check rider insures against loss from counterfeit checks and other negotiable instruments. The coverage applies whether or not the counterfeit instruments are forged.

### *Service Contractors*

The service-contractor rider covers loss resulting from fraudulent or dishonest acts committed by a servicing contractor. A "servicing contractor" services real estate and home-improvement mortgages, as well as tax and insurance escrow accounts; manages real property; or provides other related services. The coverage extends to losses resulting from the contractor's failure to forward collected funds to the bank when the servicing contractor has committed to do so.

### *Money-Order Issuer's*

With a money-order-issuer's rider, coverage is expanded to authorized third parties that issue registered checks or personal money orders on behalf of the insured.

## Liability Insurance

### *Electronic and Computer Crimes*

To broaden the electronic and computer-systems rider that is normally attached to the FIB, an additional electronic and computer-crime rider may be purchased. This rider is a "companion policy" that covers losses the bank may incur from having (1) transferred, paid, or delivered any funds or property; (2) established any credit; or (3) debited any account or given value as a direct result of fraudulent input of electronic data or computer instructions into the insured's computer. These losses may result from someone's unauthorized access to a terminal or the bank's communications lines, or from the fraudulent preparation of tapes or computer programs. Under this rider, coverage may include electronic funds transfer systems, the bank's proprietary systems, and voice instructions given over the telephone. Losses caused by software programmers and consultants, ATM systems, computer viruses, software piracy, computer extortion, and facsimiles may also be covered.

### *Excess Bank Employee Dishonesty Bond*

The excess bank employee dishonesty bond adds limits over and above the FIB. Often an FIB cannot be purchased with limits that are large enough to satisfy the risk-transfer needs of larger banks. When this occurs, the bank may purchase an excess bond that would respond if a claim is larger than the per-occurrence limits on the FIB or if the aggregate limit of the FIB has been exhausted. The most common form of this coverage is the excess bank employee dishonesty blanket bond, Standard Form No. 28.

### *Combination Safe Depository*

Combination safe depository insurance consists of two coverage sections that can be purchased

together or separately. Coverage (A) applies to losses when the bank is legally obligated to pay for loss of a customer's property held in safe deposit boxes (including loss from damage or destruction). Coverage (B) generally covers loss, damage, or destruction of property in customers' safe deposit boxes, whether or not the bank is legally liable, when the loss results from an activity other than employee dishonesty, such as robbery or burglary.

### *Directors' and Officers' Liability*

Directors' and officers' (D&O) liability insurance usually has three coverage parts: Side A, Side B, and Entity Securities Coverage (C). Side A covers the directors and officers individually for alleged wrongful acts. Side B reimburses the bank for money it has paid to or on behalf of its directors and officers to indemnify them for damages they may be liable for as a result of alleged wrongful acts. Entity Securities Coverage protects the corporation against securities claims. Subject to many exclusions and definitions, a "wrongful act" means any actual or alleged act, error, omission, misstatement, misleading statement, neglect, or breach of duty. D&O policies are primarily written on a claims-made basis. Larger banks will purchase excess D&O coverage. Like the FIB, there are numerous coverages or enhancements that can be endorsed onto a D&O policy.

*Entity errors and omissions.* The entity errors and omissions (E&O) insurance rider extends coverage to the financial institution as an entity for wrongful acts. A separate, more robust E&O policy may also be purchased. The separate policy is commonly referred to as bankers' professional liability.

*Fiduciary liability and ERISA errors and omissions.* Fiduciary liability (or fiduciary errors and omissions) extends insurance coverage for management of the bank's own employee pension or profit-sharing plans. A separate, more robust fiduciary policy may be purchased to expand further the coverage of the bank's management of its own plans. Without this additional special endorsement, neither the fiduciary errors and omissions nor the bank's directors' and officers' liability insurance will cover liability arising under the Employee Retirement Income Secu-

urity Act of 1974 (ERISA). For protection against exposure arising from a breach of fiduciary duty under ERISA, a special ERISA errors and omissions endorsement is required (also called fiduciary or employee benefit plan liability). In addition to bank trust departments, banks whose only fiduciary responsibilities relate to their employee benefit plan should consider this coverage. A related specialized coverage called IRA/Keogh errors and omissions is also available.

For properties held or managed by a bank's trust department, a master or comprehensive policy is often obtained instead of individual policies. A master policy protects the trust-account properties from fire or other loss and insures the accounts and the bank against third-party liability in connection with the properties. The master policy does not usually cover claims by trust customers against the bank for negligence, errors, or violations resulting in loss to fiduciary accounts. However, separate fiduciary (or trust department) errors and omissions policies incorporate these areas.

### *Trust Errors and Omissions*

Trust errors and omissions insurance provides coverage for wrongful acts while the bank is acting as trustee, guardian, conservator, or administrator. This is a claims-made policy that can be endorsed onto the D&O policy.

### *Employment-Practices Liability*

Employment-practices liability (EPL) insurance provides coverage for an entity against employee claims of wrongful termination, discrimination, sexual harassment or "wrongful employment acts." This is usually a claims-made policy that can be endorsed onto the D&O policy.

### *Bankers' Professional Liability*

Bankers' professional liability (BPL-E&O) provides coverage for claims resulting from any actual or alleged wrongful acts, errors, or omissions bank employees commit in the performance of professional duties. Coverage can be broadened to include securities E&O, insurance agent E&O, brokerage service E&O, and notary E&O.

### *Mortgage Impairment*

Mortgage-impairment insurance coverage protects the bank's interest, as mortgagee, from loss when contractually required insurance on real property held as collateral has inadvertently not been obtained. Upon discovery of the lack of required coverage, the bank has a limited time to either induce the borrower to obtain the required insurance or to place the insurance on its own.

### *Mortgage Errors and Omissions*

Mortgage errors and omissions insurance, a broader version of mortgage-impairment coverage, provides coverage for direct damage and E&O losses to either the bank or the borrower. Mortgage E&O coverage also applies to the bank's mishandling of real estate taxes, life and disability insurance, and escrowed insurance premiums. Claims must result in a loss to the mortgaged property.

### *Commercial General Liability*

Commercial general liability (CGL) insurance protects against claims of bodily injury or property damage for which the business may be liable and which may arise from the bank's premises, operations, and products. In addition to bodily injury and property damage, CGL can include liability coverage for various other offenses that might give rise to claims, such as libel, slander, false arrest, and advertising injury. A CGL policy can be underwritten on either an occurrence or a claims-made basis.

### *Workers' Compensation and Employers' Liability*

Workers' compensation insurance covers injuries or deaths of employees caused by accidents in the course of employment. Workers' compensation insurance consists of two basic coverage parts: statutory benefits and employers' liability (EL). The two are mutually exclusive remedies to an employee injured on the job. EL protects a company from a lawsuit filed by an employee, while statutory benefits coverage provides medical care and long-term disability, death, or other benefits. State laws govern these provisions, so the provisions differ from state to state. The

statutory coverage of workers' compensation is a no-fault system intended to benefit both the injured employee and the employer.

### *Automobile Liability and Physical Damage*

Automobile liability insurance provides third-party liability protection for bodily injury or property damage resulting from accidents that involve the bank's vehicles. First-party coverage for damage to the vehicles is also provided. This coverage should be extended to include—

- nonowned and hired coverage, if employees use personal autos or rent autos while on bank business;
- coverage for autos that have been repossessed; and
- garage-keeper's liability, if the bank rents its parking facilities to customers or the public.

### *Umbrella and Excess Liability*

Umbrella and excess liability insurance offers additional liability limits in excess of the coverage limits of any policy over which it "attaches" or becomes effective. Basic umbrella coverage attaches to CGL and automobile insurance and to the employers' liability section of workers' compensation policies. An excess liability policy attaches over an umbrella policy. More complex insurance programs may include both umbrella and excess liability policies that attach over the D&O, E&O, EPL, or other insurance.

### *Property Insurance*

Several types of insurance coverage are available to help banks recover from property damage. Some of the more common types of property coverages are briefly described below.

#### *Broad Form Property Insurance*

Property insurance insures against the loss of or damage to real and personal property. The loss or damage may be caused by perils such as fire,

theft, windstorm, hail, explosion, riot, aircraft, motor vehicles, vandalism, malicious mischief, riot and civil commotion, and smoke.

### *Fire*

Fire insurance covers all losses directly attributed to fire, including damage from smoke or water and chemicals used to extinguish the fire. Additional fire damage for the building contents may be included, but often is written in combination with the policy on the building and permanent fixtures. Most fire insurance policies contain “co-insurance” clauses, meaning that insurance coverage must be maintained at a fixed proportion of the replacement value of the building. If a bank fails to maintain the required relationship of protection, all losses will be reimbursed at the ratio of the amount of the insurance carried to the amount required, applied to the value of the building at the time of the loss. When determining insurable value for fire insurance purposes, the basis typically is the cost of replacing the property with a similar kind or quality at the time of loss. Different types of values, however, may be included in policies, and care should be taken to ensure that the bank is calculating the correct value for its needs.

### *Business Personal Property*

Traditionally known as “contents” insurance, business personal property insurance affords insurance protection coverage for the furniture, fixtures, equipment, machinery, merchandise, materials, and all other personal property owned by the bank and used in its business.

### *Blanket Coverage*

Blanket insurance covers, in a single contract, either multiple types of property at a single location or one or more types of property at multiple locations.

### *Builder’s Risk*

Builder’s-risk insurance is commercial property coverage specifically for buildings that are in the course of construction.

### *Business Interruption*

*Business-interruption insurance* indemnifies the insured against losses arising from its inability to continue normal operations and functions of the business. Coverage is triggered by the total or partial suspension of business operations due to the loss of, loss of use of, or damage to all or part of the bank’s buildings, plant machinery, equipment, or other personal property, when the loss is the result of a covered cause.

*Contingent business-interruption insurance* is also available to cover the bank’s loss of earnings caused by a loss to another business that is one of its major suppliers or customers. This insurance is also known as “business income from dependent properties.”

### *Crimes*

Crime insurance covers money, securities, merchandise, and other property from various criminal causes of loss, such as burglary, robbery, theft, and employee dishonesty.

### *Data Processing*

Data processing insurance coverage provides loss protection if data processing systems break down. This insurance also covers the additional expense incurred in making the system operational again.

### *Difference in Conditions*

A difference-in-conditions (DIC) insurance contract is a separate coverage that expands or supplements property insurance that was written on a named-perils basis. A DIC policy will cover the property on an all-risk basis, subject to certain exclusions.

### *Ocean and Inland Marine*

*Ocean marine insurance* covers ships and their cargo against such causes as fire, lightning, and “perils of the seas.” These include high winds, rough waters, running aground, and collision with other ships or objects.

*Inland marine insurance* was originally developed to provide coverage for losses to

cargo transported over land. It now covers limited types of property in addition to goods in transit.

### *Valuable Papers and Destruction of Records*

Valuable-papers and destruction-of-records insurance coverage is for the physical loss or damage to valuable papers and records of the insured. The coverage includes practically all types of printed documents or records except money.

### *Accounts Receivable*

Accounts-receivable insurance covers losses that occur when an insured is unable to collect outstanding accounts because of damage to or destruction of the accounts-receivable records that was caused from a peril covered in the policy.

### *Cash Letters*

Cash-letter insurance covers the costs for reproducing cash-letter items and items that remain uncollectible after a specified period of time. Generally, these policies do not cover losses due to dishonest acts of employees.

### *First-Class, Certified, and Registered Mail*

The insurance coverage for first-class, certified, and registered mail provides protection on the shipment of property sent through the mail, as well as during transit by messenger or carrier to and from the post office. The insurance is principally used to cover registered mail in excess of the maximum \$25,000 insurance provided by the U.S. Postal Service.

### *Commercial Multiple Peril*

Commercial multiple peril insurance encompasses a range of insurance coverages, including property and liability. Small institutions may purchase this package policy when stand-alone policies are excessive or inefficient.

## Life Insurance

Common types of life insurance policies purchased by banks are described below.

### *Key Person*

When the death of a bank officer, or key person, would be of such consequence to the bank as to give it an insurable interest, key-person life insurance would insure the bank on the life of this individual.

### *Split-Dollar*

In split-dollar life insurance, the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, death benefit, or both. See SR-93-37 (“Split-Dollar Life Insurance,” June 18, 1993) and its attachments for further discussion of the Federal Reserve’s position on these arrangements between bank holding companies and their subsidiary banks.

### *Bank-Owned*

Bank-owned life insurance consists of tax-advantaged insurance policies that are purchased to cover the lives of bank officers and other highly compensated employees. The policies may be used as a funding mechanism for employee pension and benefit plans. The bank is the owner and beneficiary of the policy, and the cash value of the policy is considered an asset of the bank.

## Aircraft or Aviation Insurance

Although aviation-liability exposures are frequently overlooked in the myriad of other financial institution exposures, they have tremendous potential for large catastrophic losses and must be addressed by senior risk-management executives at all financial institutions. Often hidden or obscure, aviation liability ranges from the more typical owned and nonowned liability and physical-damage exposures to the more exotic exposures from hangar-keepers, aviation products, and airport or heliport premises. In view of the specialized nature of aviation exposures, it is

important that the bank deal with knowledgeable and experienced agents or brokers and underwriters in developing its aviation insurance program. While exposure categories overlap significantly, the following summary highlights the key areas of concern to most financial institutions.

### *Aviation Liability*

Aviation liability insurance can be written to include aviation-products liability, all owned or nonowned exposures, and passenger liability. A bank's umbrella liability insurance program should also apply over the aviation policy's limit.

### *Nonowned Exposures*

While many banks do not feel the need for aviation insurance because they do not own an aircraft, they may overlook liability exposures from nonowned aircraft and may, in fact, need this coverage. For example, an employee may use a personal aircraft on bank business, or lease or rent an aircraft to ferry customers or employees to a distant meeting. Financing or leasing an aircraft could create a nonowned exposure, even though the aircraft is not under bank control.

Most aviation-underwriting markets have programs available to meet the above exposures. However, additional exposures may require special coverage. Banks should consider the following situations:

- If the bank repairs and maintains the aircraft, it may incur a products-liability exposure after control is relinquished to others, such as when the aircraft is sold.
- If the bank finances aircraft, maintaining only a security interest, it becomes an owner when it repossesses the aircraft. In this case, there could be a definite need for both liability and physical-damage coverage. The coverage may be written at the time of repossession or negotiated in advance of the need for it. The bank should not attempt to continue coverage for its exposure under the borrower's policy.

### *All-Risk Physical Damage*

To protect the bank's security interest in an

aircraft hull, borrowers should be required to maintain full-value, all-risk physical-damage insurance (both ground-risk and in-flight coverage) in favor of the bank. However, a number of warranties in aircraft insurance policies could void the contract, so bankers are further advised to require that a borrower's hull insurance policy contain a breach-of-warranty endorsement to protect the bank if the borrower or owner violates provisions of the policy. The underwriter should agree to give the bank at least 30 days' advance notice of any change in the policy. Depending on the use of the aircraft, special consideration should be given to the territorial limits of coverage, as well as to confiscation protection. Since breach-of-warranty endorsements, like aircraft insurance policies, are far from standard, it is important that the bank understand and agree with the underwriter's language. It is particularly appropriate to review the consequences of potential recovery to the lien holder if the aircraft is damaged while a delinquency exists on the note.

### *Bank as Lessor*

If the bank's security interest is that of the lessor, aviation liability insurance should be carried by the bank as lessor and also by the customer as lessee. In certain cases, it may be appropriate to require the lessee, through his or her underwriter, to provide the equivalent of the breach-of-warranty endorsement to the liability program and physical-damage coverage. The bank may also consider obtaining contingent lessor's liability.

### *Airport Premises and Hangar-Keepers*

Airport-premises and hangar-keeper's insurance apply if the bank repossesses real estate on which an airport facility exists and continues to operate, or if the bank permits use of the facility pending further sale. In either case, the bank may assume liability exposures associated with the control tower, as well as airport-premises liability. Both the bank's comprehensive general liability and aviation liability programs should be reviewed for proper coverage.

If the bank owns or operates a hangar for its aircraft and attempts to share the burden of costs with others by renting aircraft space, it can pick up exposure to hangar-keeper's liability, unless

the contract is properly worded. Appropriate consideration should be given to hold-harmless indemnification clauses, any regular or special insurance requirements, and waivers of subrogation.

### *Accidental Death and Dismemberment and Travel*

Accidental death and dismemberment and travel insurance is another aspect of aviation insurance that banking institutions should consider. Many insurance programs for accidental death and dismemberment and corporate business travel accidents exclude coverage in corporate-owned, -leased, or -hired aircraft. Banks need to review the language of these policies carefully to be certain that they provide necessary and adequate coverages for the use of such aircraft.

## RECORDKEEPING

The diversity of available insurance policies and their coverages emphasize the need for banks to maintain a concise, easily referenced schedule of their insurance coverage, referred to as the “schedule of insurance.” These records should include the following information:

- insurance coverages provided, with major exclusions detailed
- the underwriter
- deductible amounts
- upper limits on policies
- terms of the policies

- dates that premiums are due
- premium amounts
- claim-reporting procedures

In preparation for policy renewal, the bank’s risk manager and insurance broker organize much of the bank’s relevant insurance data into a “submission.” The submission may include—

- historical, current, and forecasted exposure information, such as sales, number and type of employees, property characteristics and values, and number and type of autos;
- loss and claim history by line of insurance, including detailed information on large claims, loss development, and litigation;
- information on company risk-management policies and financials; and
- specifications on desired coverages, terms and conditions, limits, deductibles, and payment plans.

The submission is delivered to the insurance company underwriter and forms the basis for determining premiums, rates, limits, and the program structure. The information may give the examiner a sense of why premiums and coverages change from year to year and whether purchased limits are sufficient.

Banks should retain the original policies and supporting documents for appropriate time periods. Records of losses should also be maintained, regardless of whether the bank was reimbursed. This information indicates areas where internal controls may need to be improved and is useful in measuring the level of risk exposure in a particular area.



# Management of Insurable Risks

## Examination Objectives

Effective date May 2002

## Section 4040.2

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1. To determine whether insurance is effectively integrated into the operational-risk-management program, and whether the insurance is appropriate, in light of the institution's internal-control environment.
2. To determine if insurance coverage adequately protects against significant or catastrophic loss.
3. To determine if recordkeeping practices are sufficient to enable effective risk and insurance management.
4. To ascertain if, and ensure that, the risk manager has initiated corrective action when policies, practices, procedures, or internal controls are deficient or when violations of banking laws and regulations have been noted.

# Management of Insurable Risks

## Examination Procedures

Effective date May 2002

## Section 4040.3

1. If selected for implementation, complete or update the “Bank Risk and Insurance Management” section of the internal control questionnaire.
  2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. From the examiner who is assigned to “internal control,” obtain a listing of any deficiencies noted in the latest review conducted by internal or external auditors and risk managers. Determine if appropriate corrections have been made.
  3. Determine if the bank has designated a qualified risk manager, with expertise in insurance programs, to be responsible for loss control. If not, determine which officer handles the risk- and insurance-management function and whether external consultants are employed in designing the insurance program.
  4. Obtain the bank’s schedule of insurance policies in force and the renewal submissions. If the bank does not maintain a schedule, request that the bank complete a schedule of existing insurance coverage.
    - a. Determine whether there have been any material changes in insurance coverage, limits, or deductibles since the last examination and the reasons for such changes. Do the changes reflect—
      - revised business strategies, the bank structure, operating processes, or technology systems that affect insurable risks, and
      - shifts to self-insurance or co-insurance or a change in insurance carriers?
    - b. If there have been material changes, determine how they are being managed.
  5. Using the bank-prepared summary of insurance coverage, determine that coverage conforms to the guidelines for maximum loss exposure, as established by the board of directors.
    - a. Determine whether the use of insurance is in accordance with board-approved risk-management policies and guidelines.
    - b. If the bank self-insures, determine what methods are used for this purpose; how the value of self-insurance is quantified; and how “premiums” are accounted for, funded, allocated, and tracked.
  6. Determine whether insurance coverage provides adequate protection for the bank. The quality of internal controls and the audit function must be considered when making this assessment.
    - a. Determine whether the bank manages its insurance coverage as an element of the operational-risk-management program.
    - b. Determine whether the insurance program is managed on a corporate-wide basis or within each business unit.
    - c. Identify any products, processes, or systems that the bank is not able to obtain insurance coverage for and determine how the associated risk is being managed.
    - d. Determine whether the bank maintains a database of operational-loss events, the comprehensiveness of the database, and the claims history of operational losses.
    - e. Review the due-diligence process used to assess the qualifications of providers of insurance coverage, including primary reinsurers.
  7. If the bank’s fidelity insurance has lapsed, determine that the appropriate Federal Reserve Bank has been notified.
  8. Determine that the bank has adequate procedures to ensure that—
    - a. reports of losses are filed with the bonding company pursuant to policy provisions,
    - b. premiums are paid before policy expiration dates,
    - c. policies are renewed without a lapse of coverage at expiration dates, and
    - d. material changes in exposures are reported to the bank’s insurance agent or broker and result in appropriate insurance-policy endorsements.
- If the procedures are deficient, verify that reports have been filed as required and premiums have been paid.
9. Review any significant financial institution bond claims that were filed since the last examination to determine—

- a. any adverse effect on the bank's condition,
  - b. whether the incident (or incidents) reflects any deficiencies with respect to internal controls and procedures, and
  - c. whether management has taken appropriate steps to correct any deficiencies and made appropriate reports to the board of directors.
10. Prepare, in appropriate report form, and discuss with appropriate officers—
- a. recommended corrective action when policies, practices, procedures, or internal controls are deficient;
  - b. recommended improvements in the risk-management program that relate to insurance;
  - c. important areas in which insurance coverage is either nonexistent or inadequate in view of current circumstances; and
  - d. any other deficiencies noted.
11. Update the workpapers with any information that will facilitate future examinations.

# Management of Insurable Risks

## Internal Control Questionnaire

Effective date May 2002

## Section 4040.4

Review the bank's internal controls, policies, practices, and procedures for its own insurance coverage. The bank's risk-management system should be documented completely and concisely and should include, where appropriate, the risk-assessment matrix, a narrative description, flow-charts, the schedule of insurance coverage, policy forms, renewal submissions, and other pertinent information.

### BANK RISK AND INSURANCE MANAGEMENT

1. Does the bank have established insurance guidelines that provide for—
  - a. a reasonably frequent, and at least annual, determination of risks the bank assumes or transfers, including high-dollar and low-probability events?
  - b. limits as to the amount of risk that may be retained or self-insured?
  - c. periodic appraisals of major fixed assets to be insured?
  - d. a credit or financial analysis of the insurance companies who have issued policies to the bank?
2. Does the bank have a risk manager who is responsible for assessing and developing controls to deal with the consolidated risks of the institution?
3. Is the bank's insurance program managed as an element of its overall operational-risk-management program; that is, are insurance coverages reviewed and coordinated by the person handling the operational-risk-management function?
4. Does the bank use the services of a professionally knowledgeable insurance agent, broker, direct writer, or consultant to assist in selecting and providing advice on alternative means of providing insurance coverage?
5. Does the bank's security officer coordinate his or her activities with the person responsible for handling the operational-risk-management function?
6. Does the bank maintain a concise, easily referenced schedule of existing insurance coverage?
7. Does the bank maintain records, by type of risk, to facilitate an analysis of the bank's experience in costs, claims, losses, and settlements under the various insurance policies in force?
8. Is a complete schedule of insurance coverage presented to the board of directors at least annually for review and approval? Does the schedule include the respective insurance premiums (net costs), claims, and loss experience, and is this information reviewed as part of this process?

### CONCLUSION

1. Is the foregoing information an adequate basis for evaluating internal control; that is, there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

# Purchase and Risk Management of Life Insurance

Effective date November 2005

## Section 4042.1

State member banks may purchase bank-owned life insurance (BOLI) as principal if such purchases are permitted for national banks and permitted under state law. The legal authority and guidance for acquiring permissible BOLI and for engaging in insurance activities is discussed within the following interagency statement. When such insurance purchases or insurance activities are not permissible for national banks, a determination of permissibility depends on a decision of the FDIC (1) that the investment or activity would not pose any significant risk to the insurance fund and (2) that the bank continues to comply with the required capital standards.

The bank supervisory agencies have concerns that some banks have committed a significant amount of capital to BOLI without having an adequate understanding or a proper assessment of the full array of risks it poses—especially risks that are difficult to measure, such as liquidity, transaction/operational, reputation, and compliance/legal risks. Banks are therefore expected to implement appropriate risk-management processes, including meaningful risk limits, before implementing or adding to a BOLI program. The following interagency guidance was developed for banks and savings associations (institutions) and examination staff to help ensure that risk-management practices for BOLI are consistent with safe and sound business practices. The interagency statement was issued on December 7, 2004.

### INTERAGENCY STATEMENT ON THE PURCHASE AND RISK MANAGEMENT OF LIFE INSURANCE

This interagency statement<sup>1</sup> provides general guidance for banks and savings associations (institutions) regarding supervisory expectations for the purchase of and risk management for BOLI. Guidance is also provided for split-dollar arrangements and the use of life insurance as security for loans. The agencies are providing

this guidance to help ensure that institutions' risk-management processes for BOLI are consistent with safe and sound banking practices. Among the safe and sound banking practices discussed in this statement are (1) the need for senior management and board oversight of BOLI, including both a thorough pre-purchase analysis of risks and rewards and post-purchase risk assessment and (2) the permissibility of BOLI purchases and holdings, as well as their risks and associated safety-and-soundness considerations. The statement's appendix [titled appendix A for this section of the manual] contains a discussion of insurance types and the purposes for which institutions commonly purchase life insurance, as well as a glossary of BOLI-related terminology [titled appendix B for this section].

The statement's guidance for the pre-purchase analysis of life insurance applies to all BOLI contracts entered into after December 7, 2004. The guidance concerning the ongoing risk management of BOLI subsequent to its purchase applies to all holdings of life insurance regardless of when purchased. Institutions that purchase life insurance after December 7, 2004, that are not in compliance with this guidance may be subject to supervisory action. Institutions that entered into BOLI contracts before this date will be evaluated according to each agency's pre-purchase guidance in effect at that time.

Compliance with the supervisory guidance in this statement regarding permissible uses for insurance (e.g., recovery of the costs of providing benefits) does not determine whether the policy satisfies state insurable interest requirements.

### Legal Authority

National banks may purchase and hold certain types of life insurance under 12 USC 24 (Seventh), which provides that national banks may exercise "all such incidental powers as shall be necessary to carry on the business of banking." Federal savings associations also may purchase and hold certain types of life insurance incidental to the express powers granted under the Home Owners' Loan Act. The OCC and OTS have delineated the scope of these authorities through various interpretations addressing the

1. Adopted by the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (the agencies).

permissible use of life insurance by national banks and federal savings associations.

Under these authorities, national banks and federal savings associations may purchase life insurance in connection with employee compensation and benefit plans, key-person insurance, insurance to recover the cost of providing pre- and post-retirement employee benefits, insurance on borrowers, and insurance taken as security for loans. The OCC and OTS may approve other uses on a case-by-case basis.

National banks and federal savings associations may *not* purchase life insurance—

- for speculation;
- to provide funds to acquire shares of stock from the estate of a major shareholder upon the shareholder's death, for the further purpose of controlling the distribution of ownership in the institution;
- as a means of providing estate-planning benefits for insiders, unless the benefit is a part of a reasonable compensation package; or
- to generate funds for normal operating expenses other than employee compensation and benefits.

National banks and federal savings associations may not hold life insurance in excess of their risk of loss or cost to be recovered. For example, once an individual no longer qualifies as a key person because of retirement, resignation, discharge, change of responsibilities, or for any other reason, the risk of loss has been eliminated. Therefore, national banks and federal savings associations may be required to surrender or otherwise dispose of key-person life insurance held on an individual who is no longer a key person. Typically, term or declining term insurance is the most appropriate form of life insurance for key-person protection.

National banks and federal savings associations may hold equity-linked variable life insurance policies (that is, insurance policies with a return tied to the performance of a portfolio of equity securities held in a separate account<sup>2</sup> of the insurance company) only for the purpose of

economically hedging their equity-linked obligations under employee benefit plans. As discussed more fully in the section on “Price Risk,” for equity-linked variable life insurance holdings to be permissible, the national bank or federal savings association must demonstrate that—

- it has a specific, equity-linked obligation; and
- both at the inception of the hedge and on an ongoing basis, changes in the value of the equity-linked variable life insurance policy are highly correlated with changes in the value of the equity-linked obligation.

If a national bank or federal savings association does not meet these requirements, the equity-linked variable life insurance holdings are not permissible. The use of equity-linked variable life insurance holdings as a long-term hedge against general benefit costs is not permissible because the life insurance is not hedging a specific equity-linked liability and does not meet the “highly correlated” requirement.

As a general matter, the ability of state-chartered banks to purchase insurance (including equity-linked variable life insurance) is governed by state law. In some instances, state laws permit state-chartered banks to engage in activities (including making investments) that

2. A separate account is a design feature that is generally available to purchasers of whole life or universal life whereby the policyholder's cash surrender value is supported by assets segregated from the general assets of the carrier. Under such an arrangement, the policyholder neither owns the underlying separate account nor controls investment decisions (e.g., timing of investments or credit selection) in the underlying separate account that is created by the insurance carrier on its behalf. Nevertheless, the policyholder assumes all investment and price risk.

go beyond the authority of a national bank. The Federal Deposit Insurance Act (section 24) generally requires insured state-chartered banks to obtain the FDIC's consent before engaging as principal in activities (including making investments) that are not permissible for a national bank. Similarly, the Federal Deposit Insurance Act (section 28) generally requires a state-chartered savings association to obtain the FDIC's consent prior to engaging as principal in activities (including making investments) that are not permissible for a federal savings association. While insured state-chartered banks and state savings associations may seek the FDIC's consent to make purchases of life insurance that would not be within the authority of a national bank or federal savings association, such banks and savings associations should be aware that the FDIC will not grant permission to make life insurance purchases if the FDIC determines that doing so would present a significant risk to the deposit insurance fund or that engaging in such purchases is inconsistent with the purposes of federal deposit insurance.

## Accounting Considerations

Institutions should follow generally accepted accounting principles (GAAP) applicable to life insurance for financial and regulatory reporting purposes. Financial Accounting Standards Board (FASB) Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance" (TB 85-4), discusses how to account for holdings of life insurance. Under TB 85-4, only the amount that could be realized under an insurance contract as of the balance-sheet date (that is, the CSV reported to the institution by the carrier, less any applicable surrender charges not reflected by the insurance carrier in the reported CSV) is reported as an asset. The guidance set forth in TB 85-4 concerning the carrying value of insurance on the balance sheet is generally appropriate for all forms of BOLI.

An institution may purchase multiple permanent insurance policies from the same insurance carrier with each policy having its own surrender charges. In some cases, the insurance carrier will issue a rider or other contractual provision stating that it will waive the surrender charges if all of the policies are surrendered at the same time. Because it is not known at any balance-sheet date whether one or more of the policies

will be surrendered before the deaths of those insured, the possibility that the institution will surrender all of these policies simultaneously and avoid the surrender charges is a gain contingency. Under FASB Statement No. 5, "Accounting for Contingencies," "[c]ontingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization." Accordingly, an institution should report each of the insurance policies on its balance sheet at the policy's CSV reported by the insurance carrier, less any applicable surrender charges not reflected in the reported CSV, without regard to the existence of the rider.

In accordance with the instructions for Consolidated Reports of Condition and Income and Thrift Financial Reports, an institution should report the carrying value of its BOLI holdings as an "other asset" and the earnings on these holdings should be reported as "other noninterest income."

The agencies have seen a number of cases in which institutions have failed to account properly for a type of deferred compensation agreement, commonly referred to as a revenue-neutral plan or an indexed retirement plan. The accounting for such plans is separate and distinct from the accounting for BOLI. However, because many institutions buy BOLI to help offset the cost of providing such deferred compensation, the agencies have issued guidance addressing the accounting requirements for both deferred compensation agreements and BOLI. See the Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance, dated February 11, 2004, for a complete description, including examples, of the appropriate accounting treatment.

## Supervisory Guidance on BOLI

Before entering into a BOLI contract, institutions should have a comprehensive risk-management process for purchasing and holding BOLI. A prudent risk-management process includes—

- effective senior management and board oversight;
- comprehensive policies and procedures, including appropriate limits;

- a thorough pre-purchase analysis of BOLI products; and
- an effective ongoing system of risk assessment, management, monitoring, and internal control processes, including appropriate internal audit and compliance frameworks.

The risks associated with temporary (term) insurance are significantly less than those arising from holdings of permanent insurance. Accordingly, the risk-management process for temporary insurance may take this difference into account and need not be as extensive as the risk-management process for permanent insurance.

### *Senior Management and Board Oversight*

The safe and sound use of BOLI depends on effective senior management and board oversight. Regardless of an institution's financial capacity and risk profile, the board must understand the complex risk characteristics of the institution's insurance holdings and the role this asset is intended to play in the institution's overall business strategy. Although the board may delegate decision-making authority related to purchases of BOLI to senior management, the board remains ultimately responsible for ensuring that the purchase and holding of BOLI is consistent with safe and sound banking practices.

An institution holding life insurance in a manner inconsistent with safe and sound banking practices is subject to supervisory action. Where ineffective controls over BOLI risks exist, or the exposure poses a safety-and-soundness concern, the appropriate agency may take supervisory action against the institution, including requiring the institution to divest affected policies, irrespective of potential tax consequences.

### *Policies and Procedures*

Consistent with prudent risk-management practices, each institution should establish internal policies and procedures governing its BOLI holdings, including guidelines that limit the aggregate CSV of policies from any one insurance company as well as the aggregate CSV of policies from all insurance companies. When establishing these internal CSV limits, an institution should consider its legal lending limit, the

capital concentration threshold, and any applicable state restrictions on BOLI holdings.<sup>3</sup> In this regard, given the liquidity, transaction/operational, reputation, and compliance/legal risks associated with BOLI, it is generally not prudent for an institution to hold BOLI with an aggregate CSV that exceeds 25 percent of the institution's capital as measured in accordance with the relevant agency's concentration guidelines.<sup>4</sup> Therefore, the agencies expect an institution that plans to acquire BOLI in an amount that results in an aggregate CSV in excess of 25 percent of capital, or any lower internal limit, to gain prior approval from its board of directors or the appropriate board committee. The agencies particularly expect management to justify that any increase in BOLI resulting in an aggregate CSV above 25 percent of capital does not constitute an imprudent capital concentration. An institution holding BOLI in an amount that approaches or exceeds the 25 percent of capital concentration threshold can expect examiners to more closely scrutinize the risk-management policies and controls associated with the BOLI assets and, where deficient, to require corrective action.

When seeking the board's approval to purchase or increase BOLI, management should inform the board members of the existence of this interagency statement, remind them of the illiquid nature of the insurance asset, advise them of the potential adverse financial impact of early surrender, and identify any other significant risks associated with BOLI. Such risks might include, but are not limited to, the costs associated with changing carriers in the event of a decline in the carrier's creditworthiness and the potential for noncompliance with state insurable interest requirements and federal tax law.

3. In July 1999, the OTS adopted a policy that savings associations may not invest more than 25 percent of their total capital in BOLI without first notifying and obtaining authorization from their OTS Regional Office. In order to maintain strong and effective communications with institutions under its supervision, the OTS retains this policy. The other agencies may also institute approval or notification requirements.

4. Each agency's definition of a concentration differs slightly. Institutions should refer to the definition provided by their supervisory agency when measuring the CSV of BOLI as a percentage of capital: OCC Bulletin 95-7 for national banks; FRB *Commercial Bank Examination Manual*, section 2050.1, for state member banks; FDIC *Manual of Examination Policies*, section 11.1, for insured state nonmember banks; and OTS *Thrift Activities Handbook*, section 211, for savings associations.



### *Pre-purchase Analysis*

The objective of the pre-purchase analysis is to help ensure that the institution understands the risks, rewards, and unique characteristics of BOLI. The nature and extent of this analysis should be commensurate with the size and complexity of the potential BOLI purchases and should also take into account existing BOLI holdings. A mark of a well-managed institution is the maintenance of adequate records concerning its pre-purchase analyses, usually including documentation of the purpose and amount of insurance needed.

An effective pre-purchase analysis involves the following management actions:

*Step 1—Identify the need for insurance and determine the economic benefits and appropriate insurance type.* An institution should determine the need for insurance by identifying the specific risk of loss to which it is exposed or the specific costs to be recovered. It is not appropriate to purchase life insurance to recover a loss that the institution has already incurred. An institution's purchase of insurance to indemnify it against a specific risk of loss does not relieve it from other responsibilities related to managing that risk. The type of BOLI product, e.g., general<sup>5</sup> or separate account, and its features should be appropriate to meet the identified needs of the institution. The appendix [appendix A] contains a description of insurance types and design features.

An institution should analyze the cost and benefits of planned BOLI purchases. The analysis should include the anticipated performance of the BOLI policy and an assessment of how the purchase will accomplish the institution's objectives. Before purchasing BOLI, an institution should analyze projected policy values (CSV and death benefits) using multiple illustrations of these projections provided by the carrier, some of which incorporate the institution's own assumptions. An institution should consider using a range of interest-crediting rates and mortality-cost assumptions. In some cases, the net yield (after mortality costs) could be negative, particularly for separate-account products. The potential for unfavorable net yields

underscores the importance of carefully evaluating BOLI costs and benefits across multiple scenarios, both currently and into the future.

*Step 2—Quantify the amount of insurance appropriate for the institution's objectives.* An institution should estimate the size of the employee benefit obligation or the risk of loss to be covered and ensure that the amount of BOLI purchased is not excessive in relation to this estimate and the associated product risks. When using BOLI to recover the cost of providing employee benefits, the estimated present value of the expected future cash flows from BOLI, less the costs of insurance, should not exceed the estimated present value of the expected after-tax employee benefit costs. In situations where an institution purchases BOLI on a group of eligible employees, it may estimate the size of the obligation or the risk of loss for the group on an aggregate basis and compare that to the aggregate amount of insurance to be purchased. This estimate should be based on reasonable financial and actuarial assumptions. State insurable interest laws may further restrict or limit the amount of insurance that may be purchased on a group of employees. Management must be able to support, with objective evidence, the reasonableness of all of the assumptions used in determining the appropriate amount of insurance coverage needed by the institution, including the rationale for its discount rates and cost projections.

*Step 3—Assess the vendor's qualifications.* When making a decision about vendors, an institution should consider its own knowledge of insurance risks, the vendor's qualifications, and the amount of resources the institution is willing to spend to administer and service the BOLI. Depending on the role of the vendor, the vendor's services can be extensive and may be critical to successful implementation and operation of a BOLI plan, particularly for the more complex separate-account products.

While it is possible to purchase insurance directly from insurance carriers, the vast majority of insurance purchases are made through vendors—either brokers, consultants, or agents. A vendor may design, negotiate, and administer the BOLI policy. An institution should ensure that it understands the product it is purchasing and that it selects a product that best meets its needs. Management, not just the vendor, must demonstrate a familiarity with the technical

5. A general account is a design feature that is generally available to purchasers of whole or universal life insurance whereby the general assets of the insurance company support the policyholder's CSV.

details of the institution's insurance assets, and be able to explain the reasons for and the risks associated with the product design features they have selected.

An institution that uses a vendor should make appropriate inquiries to satisfy itself about the vendor's ability to honor its long-term commitments, particularly when the vendor is expected to be associated with the institution's insurance program over an extended period of time. The institution should evaluate the adequacy of the vendor's services and its reputation, experience, financial soundness, and commitment to the BOLI product. Vendors typically earn a large portion of their commissions upon the sale of the product, yet they often retain long-term servicing responsibilities for their clients. The vendor's commitment to investing in the operational infrastructure necessary to support BOLI is a key consideration in vendor selection.

An institution should be aware that the vendor's financial benefit from the sale of insurance may provide the vendor with an incentive to emphasize the benefits of a BOLI purchase to the institution without a commensurate explanation of the associated risks. Therefore, reliance solely upon pre-packaged, vendor-supplied compliance information does *not* demonstrate prudence with respect to the purchase of insurance. An institution should not delegate its selection of product design features to its vendors. An institution that is unable to demonstrate a thorough understanding of BOLI products it has purchased and the associated risks may be subject to supervisory action.

*Step 4—Review the characteristics of the available insurance products.* There are a few basic types of life insurance products in the marketplace. These products, however, can be combined and modified in many different ways. The resulting final product can be quite complex. Furthermore, certain permanent insurance products have been designed specifically for banks. These products differ from other forms of corporate-owned life insurance (COLI) policies in that the policies designed for banks are generally structured without surrender or front-end sales charges in order to avoid having to report these charges as expenses when initially recording the carrying value. However, BOLI products may have lower net yields than COLI products due to the absence of these charges. An institution should review the characteristics of the various insurance products available, under-

stand the products it is considering purchasing, and select those with the characteristics that best match the institution's objectives, needs, and risk tolerance.

Design features of permanent insurance policies determine (1) whether the policy is a general account, separate account, or hybrid product;<sup>6</sup> (2) whether the insurance contract is a modified endowment contract (MEC) that carries certain tax penalties if surrendered; and (3) the method used to credit earnings to the policy. Some implications of these design features are discussed in more detail in the "Risk Management of BOLI" section of this interagency statement.

When purchasing insurance on a key person or a borrower, management should consider whether the institution's need for the insurance might end before the insured person dies. An institution generally may not hold BOLI on a key person or a borrower once the key person leaves the institution or the borrower has either repaid the loan, or the loan has been charged off. Therefore, the maturity of the term or declining term insurance should be structured to match the expected tenure of the key person or the maturity of the loan, respectively. Permanent insurance generally is not an appropriate form of life insurance under these circumstances.

*Step 5—Select the carrier.* To achieve the tax benefits of insurance, institutions must hold BOLI policies until the death of the insured. Therefore, carrier selection is one of the most critical decisions in a BOLI purchase and one that can have long-term consequences. While a broker or consultant may assist the institution in evaluating carrier options, the institution alone retains the responsibility for carrier selection. Before purchasing life insurance, an institution should perform a credit analysis on the selected carrier(s) in a manner consistent with safe and sound banking practices for commercial lending. A more complete discussion of the credit-analysis standards is included in the "Credit Risk" section of this interagency statement.

Management should review the product design, pricing, and administrative services of proposed carriers and compare them with the institution's needs. Management should also review the carrier's commitment to the BOLI product, as well as its credit ratings, general reputation, experi-

6. A hybrid product combines features of both general- and separate-account products.

ence in the marketplace, and past performance. Carriers not committed to general-account BOLI products may have an incentive to lower the interest-crediting rate on BOLI over time, reducing the favorable economics of the product. The interest-crediting rate refers to the gross yield on the investment in the insurance policy, that is, the rate at which the cash value increases before considering any deductions for mortality cost, load charges, or other costs that are periodically charged against the policy's cash value. Insurance companies frequently disclose both a current interest-crediting rate and a guaranteed minimum interest-crediting rate. Institutions should be aware that the guaranteed minimum interest-crediting rate may be periodically reset in accordance with the terms of the insurance contract. As a result, the potential exists for a decline in the interest-crediting rate.

While institutions can exercise what is known as a 1035 exchange<sup>7</sup> option to change carriers, there are some practical constraints to using this option. First, the institution must have an insurable interest in each individual to be insured under the new carrier's policy. In a 1035 exchange, former employees of the institution may not be eligible for coverage under the new policy because state insurable interest laws may prohibit their eligibility. Second, the original carrier may impose an exchange fee specifically applicable to such 1035 exchanges.

*Step 6—Determine the reasonableness of compensation provided to the insured employee if the insurance results in additional compensation.* Insurance arrangements that are funded by the institution and that permit the insured officer, director, or employee to designate a beneficiary are a common way to provide additional compensation or other benefits to the insured. Split-dollar life insurance arrangements are often used for this purpose. Before an institution enters into a split-dollar arrangement or otherwise purchases insurance for the benefit of an officer, director, or employee, the institution should identify and quantify its compensation objective and ensure that the arrangement is consistent with that objective. The compensation provided by the split-dollar or other insurance arrangement should be combined with all other com-

pensation provided to the insured to ensure that the insured's total compensation is not excessive. Excessive compensation is considered an unsafe and unsound banking practice. Guidelines for determining excessive compensation can be found in the Interagency Guidelines Establishing Standards for Safety and Soundness.<sup>8</sup>

Because shareholders and their family members who are not officers, directors, or employees of an institution do not provide goods or services to the institution, they should not receive compensation from the institution. This includes compensation in the form of split-dollar life insurance arrangements.

Prior to an institution's purchase of a life insurance policy to be used in a split-dollar life insurance arrangement, the institution and the insured should enter into a written agreement. Written agreements usually describe the rights of the institution, the insured individual, and any other parties (such as trusts or beneficiaries) to the policy's CSV and death benefits. It is important for an institution to be aware that ownership of the policy by the employee, a third party, or a trust (non-institution owner) may not adequately protect the institution's interest in the policy because the institution ordinarily will not have the sole right to borrow against the CSV or to liquidate the policy in the event that funds are needed to provide liquidity to the institution. Moreover, if a non-institution owner borrows heavily against the CSV, an institution's ability to recover its premium payments upon the death of the insured may be impaired.

At a minimum, an institution's economic interest in the policy should be equal to the premiums paid plus a reasonable rate of return, defined as a rate of return that is comparable to returns on investments of similar maturity and credit risk.

Split-dollar life insurance has complex tax and legal consequences. An institution considering entering into a split-dollar life insurance arrangement should consult qualified tax, legal, and insurance advisers.

*Step 7—Analyze the associated risks and the ability to monitor and respond to those risks.* An institution's pre-purchase analysis should include a thorough evaluation of all significant risks, as

7. A 1035 exchange is a tax-free replacement of an insurance policy for another insurance contract covering the same person in accordance with section 1035 of the Internal Revenue Code.

8. For national banks, appendix A to 12 CFR 30; for state member banks, appendix D-1 to 12 CFR 208; for insured state nonmember banks, appendix A to 12 CFR 364; for savings associations, appendix A to 12 CFR 570.

well as management's ability to identify, measure, monitor, and control those risks. An explanation of key risks (liquidity, transaction/operational, reputation, credit, interest rate, compliance/legal, and price) is included in the "Risk Management of BOLI" section of this interagency statement.

*Step 8—Evaluate the alternatives.* Regardless of the purpose of BOLI, a comprehensive pre-purchase analysis will include an analysis of available alternatives. Prior to acquiring BOLI, an institution should thoroughly analyze the risks and benefits, compared to alternative methods for recovering costs associated with the loss of key persons, providing pre- and post-retirement employee benefits, or providing additional employee compensation, as appropriate.

*Step 9—Document the decision.* A well-managed institution maintains adequate documentation supporting its comprehensive pre-purchase analysis, including an analysis of both the types and design of products purchased and the overall level of BOLI holdings.

## Risk Management of BOLI

Risk assessment and risk management are vital components of an effective BOLI program. In addition to conducting a risk assessment as part of a thorough pre-purchase analysis, monitoring BOLI risks on an ongoing basis is important, especially for an institution whose aggregate BOLI holdings represent a capital concentration. Management of an institution should review the performance of the institution's insurance assets with its board of directors at least annually. More-frequent reviews are appropriate if there are significant anticipated changes to the BOLI program such as additional purchases, a decline in the financial condition of the insurance carrier(s), anticipated policy surrenders, or changes in tax laws or interpretations that could have an impact on the performance of BOLI. This risk-management review should include, but not necessarily be limited to:

- *Comprehensive assessment of the specific risks discussed in this section.*<sup>9</sup>

- *Identification of which employees are, or will be, insured (e.g., vice presidents and above, employees of a certain grade level).* For example, an institution that acquires another institution that owns BOLI may acquire insurance on individuals that it would not insure under its own standards. While the acquiring institution need not correct such exceptions, it is important to know that such exceptions exist.
- *Assessment of death benefit amounts relative to employee salaries.* Such information helps management to assess the reputation and insurable interest risks associated with disproportionately large death benefits.
- *Calculation of the percentage of insured persons still employed by the institution.* Larger institutions often find that their policies insure more former employees than current employees. This information can help the institution assess reputation risk.
- *Evaluation of the material changes to BOLI risk-management policies.*
- *Assessment of the effects of policy exchanges.* Exchanges typically are costly and it is a sound practice to review the costs and benefits of such actions.
- *Analysis of mortality performance and impact on income.* Material gains from death benefits can create reputation risks.
- *Evaluation of material findings from internal and external audits and independent risk-management reviews.*
- *Identification of the reason for, and tax implications of, any policy surrenders.* In some cases, institutions have surrendered BOLI policies and incurred tax liabilities and penalties. Formal assessment of the costs and benefits of a surrender is a useful component of sound corporate governance.
- *Peer analysis of BOLI holdings.* To address reputation risk, an institution should compare its BOLI holdings relative to capital to the holdings of its peers to assess whether it is an outlier.

### Liquidity Risk

Liquidity risk is the risk to earnings and capital arising from an institution's inability to meet its obligations when they come due without incur-

9. All of the risks discussed in this section are applicable to permanent insurance. In contrast, because temporary insurance does not have a savings component or a CSV, it does not

expose an institution to liquidity, interest-rate, or price risk. These risks need not be evaluated in the comprehensive assessment of the risks of temporary insurance.

ring unacceptable losses. Before purchasing permanent insurance, management should recognize the illiquid nature of the product and ensure that the institution has the long-term financial flexibility to hold the asset in accordance with its expected use. The inability to hold the life insurance until the death(s) of the insured(s) when the death benefits will be collected may compromise the success of the BOLI plan. An institution generally does not receive any cash flow from the insurance until the death benefit is paid. Depending upon the age of the insured population, it is possible that an institution that insures a small number of employees may not recognize any cash flow from the insurance for many years. The illiquid nature of insurance assets, combined with the difficulty of projecting liquidity needs far into the future, is a major reason an institution should keep its BOLI holdings below the agencies' concentration guidelines. Examiners will consider an institution's BOLI holdings when assessing liquidity and assigning the liquidity component rating.

The purchase of BOLI may negatively affect an institution's liquidity position, both because BOLI is one of the least liquid assets on an institution's balance sheet, and because institutions normally fund BOLI purchases through the sale of liquid assets (e.g., marketable securities). To access the CSV of BOLI, the institution must either surrender or borrow against the policy. In accordance with the policy contract and federal tax laws, the surrender of a policy may subject an institution to surrender charges, tax liabilities for previously untaxed increases in the CSV, and tax penalties. Borrowing against the CSV is disadvantageous in most cases due to limitations on the ability to deduct interest on the borrowing and other possible adverse tax consequences.

A BOLI product qualifying as a modified endowment contract (MEC) for tax purposes has particular liquidity disadvantages. If an institution surrenders a MEC, it will incur a tax liability on the increase in the policy's CSV from earnings on the policy since its inception and may incur an additional tax penalty for early surrender.

In order to avoid such additional tax penalties, an institution may opt to purchase a non-MEC contract. A non-MEC contract permits the policy owner to surrender the policy without incurring the additional tax penalty that, under certain circumstances, applies to MECs. Moreover, depending on the terms of the insurance contract, an institution generally may withdraw

up to the basis (that is, the original amount invested) without creating a taxable event. However, a non-MEC policy increases in complexity if it is in the form of a separate account covered by a stable value protection (SVP) contract. An SVP contract protects the policy owner from declines in the value of the assets in the separate account arising from changes in interest rates, thereby mitigating price risk and earnings volatility. An SVP contract is most often used in connection with fixed-income investments. Institutions should recognize that SVP providers often place restrictions on the amount that may be withdrawn from the separate account, thereby reducing the liquidity of the BOLI asset. An institution considering the purchase of a non-MEC for its potential liquidity advantages compared to a MEC also should be aware of contractual provisions, such as 1035 exchange fees and "crawl-out" restrictions,<sup>10</sup> which may limit such advantages.

### *Transaction/Operational Risk*

As it applies to BOLI, transaction/operational risk is the risk to earnings and capital arising from problems caused by the institution's failure to fully understand or to properly implement a transaction. Transaction/operational risk arises due to the variety and complexity of life insurance products, as well as tax and accounting treatments. To help mitigate this risk, management should have a thorough understanding of how the insurance product works and the variables that dictate the product's performance. The variables most likely to affect product performance are the policy's interest-crediting rate, mortality cost, and other expense charges.

Transaction/operational risk is also a function of the type and design features of a life insurance contract. With a general-account product, there are only two parties to the contract: the policy owner and the insurance carrier. With a separate-account product, the insurance carrier has a separate contract with an investment manager. There could also be an SVP provider with whom the carrier has a separate contract.

Transaction/operational risk may also arise as a result of the variety of negotiable features associated with a separate-account product.

<sup>10</sup> A crawl-out restriction limits the amount of CSV eligible for a 1035 exchange or surrender over a period of time.



These include the investment options; the terms, conditions, and cost of SVP; and mortality options. Deferred acquisition costs (DAC) represent the insurance carrier's up-front costs associated with issuing an insurance policy, including taxes and commissions and fees paid to agents for selling the policy. The carrier charges the policyholder for these costs and capitalizes the DAC, including the prepayment of taxes in accordance with federal tax law. As the carrier recovers the DAC in accordance with applicable tax law, it credits the amount to the separate-account policyholder. Once it has been credited to the institution, the DAC is essentially a receivable from the carrier and, therefore, represents a general-account credit exposure.

Separate-account policies have additional transaction risks that can result from accounting requirements. Several institutions have had to restate their earnings because of contractual provisions in their policies that were ambiguous with respect to the amount of the CSV available upon surrender of the policy. Because BOLI must be carried at the amount that could be realized under the insurance contract as of the balance-sheet date, if any contractual provision related to costs, charges, or reserves creates uncertainty regarding the realization of a policy's full CSV, the agencies will require an institution to record the BOLI net of those amounts. As part of an effective pre-purchase analysis, an institution should thoroughly review and understand how the accounting rules will apply to the BOLI policy it is considering purchasing.

### *Tax and Insurable Interest Implications*

Before the purchase of BOLI and periodically thereafter, management should also explicitly consider the financial impact (e.g., tax provisions and penalties) of surrendering a policy. Recent adverse press coverage of corporate-owned life insurance (COLI) should serve as a reminder to institutions that the current tax law framework, as it applies to BOLI, is always subject to legislative changes. A tax change that makes future BOLI cash flows subject to income tax, while perhaps deemed unlikely by many institutions, would have a negative impact on the economics of the BOLI holdings. An institution should recognize that earnings from BOLI could make it subject to the alternative minimum tax.

Institutions should also recognize that their actions, subsequent to purchase, could jeopardize the tax-advantaged status of their insurance holdings. The risk that a life insurance policy could be characterized by the Internal Revenue Service (IRS) as an actively managed investment is particularly relevant to separate-account policies. Many larger institutions prefer separate-account products because of perceived lower credit risk and greater transparency (that is, explicit disclosure of costs). Assets held by the insurance company on behalf of the policy owners in the separate account are intended to be beyond the reach of the insurance company's general creditors in the event of insolvency; however, the protected status of separate-account assets is generally untested in the courts. While the separate-account structure helps to mitigate an institution's credit exposure to the insurance carrier, the institution can have no "control" over investment decisions (e.g., timing of investments or credit selection) in the underlying account. Generally, allocating separate-account holdings across various divisions of an insurance company's portfolio does not raise concerns about "control," but other actions that a policy owner takes may be construed as investment control and could jeopardize the tax-advantaged status.

To benefit from the favorable tax treatment of insurance, a BOLI policy must be a valid insurance contract under applicable state law and must qualify under applicable federal law. Institutions must have an insurable interest in the covered employee, as set forth in applicable state laws. Furthermore, the favorable tax-equivalent yields of BOLI result only when an institution generates taxable income. Institutions that have no federal income tax liability receive only the nominal interest-crediting rate as a yield. In such an environment, BOLI loses much of its yield advantage relative to other investment alternatives.

Some institutions seem to have drawn comfort from assurances from insurance carriers that the carrier would waive lack of insurable interest as a defense against paying a claim. While the carrier may indeed make a payment, such payment may not necessarily go to the institution. Such assurances may not be sufficient to satisfy the IRS requirements for a valid insurance contract, nor do they eliminate potential claims from the estate of the insured that might seek to claim insurance proceeds on the basis that the institution lacked an insurable interest.

For example, some institutions have established out-of-state trusts to hold their BOLI assets. While such trusts may have legitimate uses, such as to gain access to an insurance carrier's product, in some cases the purpose is to avoid unfavorable insurable interest laws in the institution's home state and to domicile the policy in a state with more lenient requirements. In some cases, institutions have not made employees aware that they have taken out insurance on their lives.

A recent Fifth Circuit Court of Appeals ruling demonstrates the potential danger of this approach. A Texas employer used a Georgia trust to hold life insurance policies on its employees in Texas, and the trust agreement provided that the insurable interest law of Georgia should apply. In a lawsuit brought by the estate of a deceased employee, the court ignored this provision because the insured employee was not a party to the trust agreement. It then found that the insurable interest law of Texas applied and under that state's law, the employer did not have an insurable interest in the employee. The result was that the employer was not entitled to the insurance death benefits.<sup>11</sup> The outcome in this case suggests that institutions that have used, or are considering using, an out-of-state trust to take advantage of more-favorable insurable interest laws in another state should assess whether they could be vulnerable to a similar legal challenge.

Institutions should have appropriate legal review to help ensure compliance with applicable tax laws and state insurable interest requirements. Institutions that insure employees for excessive amounts may be engaging in impermissible speculation or unsafe and unsound banking practices. The agencies may require institutions to surrender such policies.

### *Reputation Risk*

Reputation risk is the risk to earnings and capital arising from negative publicity regarding an institution's business practices. While this risk arises from virtually all bank products and services, reputation risk is particularly prevalent in BOLI because of the potential perception issues associated with an institution's owning or benefiting from life insurance on employees.

A well-managed institution will take steps to reduce the reputation risk that may arise as a result of its BOLI purchases, including maintaining appropriate documentation evidencing informed consent by the employee, prior to purchasing insurance. Some institutions assert that they make employees aware via employee handbooks, manuals, or newsletters of the possibility that the institution may acquire life insurance on them. Although such disclosure may satisfy state insurance requirements, any approach that does not require formal employee consent may significantly increase an institution's reputation risk.

Some institutions have begun to purchase separate-account, non-MEC product designs in order to address the liquidity concerns with MEC policies. One consequence of this product design choice, however, is that it has become increasingly common for institutions to insure a very large segment of their employee base, including non-officers. Because non-MEC designs have a higher ratio of death benefit to premium dollar invested, some institutions have, therefore, taken out very high death benefit policies on employees, including lower-level employees, further adding to reputation risk and highlighting the importance of obtaining explicit consent.

### *Credit Risk*

Credit risk is the potential impact on earnings and capital arising from an obligor's failure to meet the terms of any contract with the institution or otherwise perform as agreed. All life insurance policyholders are exposed to credit risk. The credit quality of the insurance company and duration of the contract are key variables. With insurance, credit risk arises from the insurance carrier's contractual obligation to pay death benefits upon the death of the insured, and if applicable, from the carrier's obligation to pay the CSV (less any applicable surrender charges) upon the surrender of the policy.

Most BOLI products have very long-term (30- to 40-year) expected time frames for full collection of cash proceeds, i.e., the death benefit. For general-account policies, the CSV is an unsecured, long-term, and nonamortizing obligation of the insurance carrier. Institutions record and carry this claim against the insurance company as an asset.

11. *Mayo v. Hartford Life Insurance Company*, 354 F.3d 400 (5th Cir. 2004).

Before purchasing BOLI, an institution should conduct an independent financial analysis of the insurance company and continue to monitor its condition on an ongoing basis. The institution's credit-risk-management function should participate in the review and approval of insurance carriers. As with lending, the depth and frequency of credit analysis (both initially and on an ongoing basis) should be a function of the relative size and complexity of the transaction and the size of outstanding exposures. Among other things, an institution should consider its legal lending limit, concentration guidelines (generally defined as the aggregate of direct, indirect, and contingent obligations and exposures that exceed 25 percent of the institution's capital), and any applicable state restrictions on BOLI holdings when assessing its broader credit-risk exposure to insurance carriers. To measure credit exposures comprehensively, an institution should aggregate its exposures to individual insurance carriers, and the insurance industry as a whole, attributable to both BOLI policies and other credit relationships (e.g., loans and derivatives exposures).

There are product design features of a BOLI policy that can reduce credit risk. As noted earlier, an institution can purchase separate-account products, where the institution assumes the credit risk of the assets held in the separate account, rather than the direct credit risk of the carrier as would be the case in a general-account policy. With separate-account policies, the insurance carrier owns the assets, but maintains the assets beyond the reach of general creditors in the event of the insurer's insolvency. However, even with a separate-account policy, the policy owner incurs some general-account credit-risk exposure to the insurance carrier associated with the carrier's mortality and DAC reserves. Amounts equal to the mortality and DAC reserves are owed to the policyholder and represent general-account obligations of the insurance carrier. In addition, the difference, if any, between the CSV and the minimum guaranteed death benefit would be paid out of the insurance carrier's general account.

A separate-account policy may have a stable value protection (SVP) contract issued by the insurance carrier or by a third party that is intended to protect the policyholder from most declines in fair value of separate-account assets. In general, the provider of an SVP contract agrees to pay any shortfall between the fair value of the separate-account assets when the

policy owner surrenders the policy and the cost basis of the separate account to the policy owner. Under most arrangements, the insurance carrier is not responsible for making a payment under the SVP contract if a third-party protection provider fails to make a required payment to it. The SVP contract thus represents an additional source of credit risk for a separate-account product. The policyholder's exposure under an SVP contract is to both the protection provider, which must make any required payment to the insurance carrier, and the carrier, which must remit the payment received from the protection provider to the institution. Because of this exposure, an institution should also evaluate the repayment capacity of the SVP provider.

State insurance regulation governing reserve requirements for insurance carriers, state guaranty funds, and reinsurance arrangements help to reduce direct credit risks from general-account exposures. Further, an institution can use a 1035 exchange to exit a deteriorating credit exposure, although most policies impose fees for the exchange. While credit risk for existing general- and separate-account policies may be low currently, the extremely long-term nature of a BOLI policy underscores the fact that credit risk remains an important risk associated with life insurance products. Strong current credit ratings offer no guarantee of strong credit ratings 20, 30, or 40 years into the future.

### *Interest-Rate Risk*

Interest-rate risk is the risk to earnings and capital arising from movements in interest rates. Due to the interest-rate risk inherent in general-account products, it is particularly important that management fully understand how these products expose the policyholder to interest-rate risk before purchasing the policy. The interest-rate risk associated with these products is primarily a function of the maturities of the assets in the carrier's investment portfolio, which often range from four to eight years. When purchasing a general-account policy, an institution chooses one of a number of interest-crediting options (that is, the method by which the carrier will increase the policy's CSV). Using the "portfolio" crediting rate, the institution will earn a return based upon the existing yield of the carrier's portfolio each year. Using the "new money" crediting rate, the institution earns a



return based upon yields available in the market at the time it purchases the policy.

Separate-account products may also expose the institution to interest-rate risk, depending on the types of assets held in the separate account. For example, if the separate-account assets consist solely of U.S. Treasury securities, the institution is exposed to interest-rate risk in the same way as holding U.S. Treasury securities directly in its investment portfolio. However, because the institution cannot control the separate-account assets, it is more difficult for the institution to control this risk. Accordingly, before purchasing a separate-account product, an institution's management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent within the separate account and ensure that the risk is appropriate for the institution. The institution also should establish monitoring and reporting systems that will enable management to monitor and respond to interest-rate fluctuations and their effect on separate-account assets.

### *Compliance/Legal Risk*

Compliance/legal risk is the risk to earnings and capital arising from violations of, or nonconformance with, laws, rulings, regulations, prescribed practices, or ethical standards. Failure to comply with applicable laws, rulings, regulations, and prescribed practices could compromise the success of a BOLI program and result in fines or penalties imposed by regulatory authorities or loss of tax benefits. Among the legal and regulatory considerations that an institution should evaluate are compliance with state insurable interest laws, the Employee Retirement Income Security Act of 1974 (ERISA), Federal Reserve Regulations O and W (12 CFR 215 and 223, respectively), the Interagency Guidelines Establishing Standards for Safety and Soundness, the requirements set forth under the "Legal Authority" section of this document, and federal tax regulations applicable to BOLI.

Tax benefits are critical to the success of most BOLI plans. Accordingly, an institution owning separate-account BOLI must implement internal policies and procedures to ensure that it does not take any action that might be interpreted as exercising "control" over separate-account assets. This is especially important for privately

placed policies in which the institution is the only policyholder associated with the separate-account assets.

When purchasing BOLI, institutions should be aware that the splitting of commissions between a vendor and the institution's own subsidiary or affiliate insurance agency presents compliance risk. The laws of most states prohibit the payment of inducements or rebates to a person as an incentive for that person to purchase insurance. These laws may also apply to the person receiving the payment. When an insurance vendor splits its commission with an institution's insurance agency that was not otherwise involved in the transaction, such a payment may constitute a prohibited inducement or rebate. Accordingly, an institution should assure itself that this practice is permissible under applicable state law and in compliance with Federal Reserve Regulation W before participating in any such arrangement. Moreover, payments to an affiliate that did not perform services for the institution could also raise other regulatory and supervisory issues.

Due to the significance of the compliance risk, institutions should seek the advice of counsel on these legal and regulatory issues.

### *Price Risk*

Price risk is the risk to earnings and capital arising from changes in the value of portfolios of financial instruments. Accounting rules permit owners of insurance contracts to account for general-account products using an approach that is essentially based on cost plus accrued earnings. However, for separate-account products without SVP, the accounting would largely be based on the fair value of the assets held in the account because this value is the amount that could be realized from the separate account if the policy is surrendered. (See "Accounting Considerations" above.) Typically, the policyholder of separate-account products assumes all price risk associated with the investments within the separate account. Usually, the insurance carrier will provide neither a minimum CSV nor a guaranteed interest-crediting rate for separate-account products. Absent an SVP contract, the amount of price risk generally depends upon the type of assets held in the separate account.

Because the institution does not control the separate-account assets, it is more difficult for it to control the price risk of these assets than if

they were directly owned. To address income-statement volatility, an institution may purchase an SVP contract for its separate-account policy. The SVP contract is designed to ensure that the amount that an institution could realize from its separate-account policy, in most circumstances, remains at or above the cost basis of the separate account to the policyholder. Institutions should understand, however, that SVP contracts protect against declines in value attributable to changes in interest rates; they do not cover default risk. Moreover, one purpose of the SVP contract is to reduce volatility in an institution's reported earnings. To realize any economic benefit of the SVP contract, an institution would have to surrender the policy. Since policy surrender is nearly always an uneconomic decision, the SVP contract provides, in a practical sense, accounting benefits only.

Before purchasing a separate-account life insurance product, management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent in the separate account and ensure that the risk is appropriate. If the institution does not purchase SVP, management should establish monitoring and reporting systems that will enable it to recognize and respond to price fluctuations in the fair value of separate-account assets.

Under limited circumstances it is legally permissible for an institution to purchase an equity-linked variable life insurance policy if the policy is an effective economic hedge against the institution's equity-linked obligations under employee benefit plans.<sup>12</sup> An effective economic hedge exists when changes in the economic value of the liability or other risk exposure being hedged are matched by counterbalancing changes in the value of the hedging instrument. Such a relationship would exist where the obligation under an institution's deferred compensation plan is based upon the value of a stock market index and the separate account contains a stock mutual fund that mirrors the performance of that index. Institutions need to be aware that this economic hedge may not qualify as a hedge for accounting purposes. Thus, the use of equity-linked variable life insurance policies to economically hedge equity-linked obligations may

not have a neutral effect on an institution's reported earnings.

Unlike separate-account holdings of debt securities, SVP contracts on separate-account equity holdings are not common. The economic hedging criteria for equity-linked insurance products lessen the effect of price risk because changes in the amount of the institution's equity-linked liability are required to offset changes in the value of the separate-account assets. If the insurance cannot be characterized as an effective economic hedge, the presence of equity securities in a separate account is impermissible, and the agencies will require institutions to reallocate the assets unless retention of the policy is permitted under federal law.<sup>13</sup>

In addition to the general considerations discussed previously, which are applicable to any separate-account product, an institution should perform further analysis when purchasing a separate-account product involving equity securities. At a minimum, the institution should:

1. Compare the equity-linked liability being hedged (e.g., deferred compensation) and the equity securities in the separate account. Such an analysis considers the correlation between the liability and the equity securities, expected returns for the securities (including standard deviation of returns), and current and projected asset and liability balances.
2. Determine a target range for the hedge effectiveness ratio (e.g., 95 to 105 percent) and establish a method for measuring hedge effectiveness on an ongoing basis. The institution should establish a process for altering the program if hedge effectiveness drops below acceptable levels. Consideration should be given to the potential costs of program changes.
3. Establish a process for analyzing and reporting to management and the board the effect of the hedge on the institution's earnings and capital ratios. The analysis usually considers results both with and without the hedging transaction.

13. Insured state banks and state savings associations may request the FDIC's consent to retain the policies, but consent will not be granted if it is determined that retaining the policies presents a significant risk to the appropriate insurance fund.

12. Insured state banks and state savings associations may make such purchases only if permitted to do so under applicable state law.

## Risk-Based Capital Treatment

If an institution owns a general-account insurance product, it should apply a 100 percent risk weight to its claim on the insurance company for risk-based capital purposes. A BOLI investment in a separate-account insurance product, however, may expose the institution to the market and credit risks associated with the pools of assets in the separate account. The assets in a pool may have different risk weights, similar to the assets held in a mutual fund in which an institution has invested. For risk-based capital purposes, if an institution can demonstrate that the BOLI separate-account policy meets the requirements below, it may choose to “look through” to the underlying assets to determine the risk weight.

### *Criteria for a Look-Through Approach*

To qualify for the “look-through” approach, separate-account BOLI assets must be protected from the insurance company’s general creditors in the event of the insurer’s insolvency. An institution should document its assessment, based upon applicable state insurance laws and other relevant factors, that the separate-account assets would be protected from the carrier’s general creditors. If the institution does not have sufficient information to determine that a BOLI separate-account policy qualifies for the look-through approach, the institution must apply the standard risk weight of 100 percent to this asset.

In addition, when an institution has a separate-account policy, the portion of the carrying value of the institution’s insurance asset that represents general-account claims on the insurer, such as deferred acquisition costs (DAC) and mortality reserves that are realizable as of the balance-sheet date, and any portion of the carrying value attributable to an SVP contract, are not eligible for the look-through approach. These amounts should be risk-weighted at the 100 percent risk weight applicable to claims on the insurer or the SVP provider, as appropriate.

### *Look-Through Approaches*

When risk-weighting a qualifying separate-account policy, an institution may apply the highest risk weight for an asset permitted in the

separate account, as stated in the investment agreement, to the entire carrying value of the separate-account policy, except for any portions of the carrying value that are general-account claims or are attributable to SVP. In no case, however, may the risk weight for the carrying value of the policy (excluding any general-account and SVP portions) be less than 20 percent.

Alternatively, an institution may use a pro rata approach to risk-weighting the carrying value of a qualifying separate-account policy (excluding any general-account and SVP portions). The pro rata approach is based on the investment limits stated in the investment agreement for each class of assets that can be held in the separate account, with the constraint that the weighted average risk weight may not be less than 20 percent. If the sum of the permitted investments across market sectors in the investment agreement is greater than 100 percent, the institution must use the highest risk weight for the maximum amount permitted in that asset class, and then proceed to the next-highest risk weight until the permitted amounts equal 100 percent.

For example, if a separate-account investment agreement permits a maximum allocation of 60 percent for corporate bonds, 40 percent for U.S. government-sponsored enterprise debt securities, and 60 percent for U.S. Treasury securities, then the institution must risk-weight 60 percent of the carrying value of the separate-account investment (excluding any portion attributable to SVP) at the 100 percent risk weight applicable to corporate bonds and the remaining 40 percent at the 20 percent risk weight for U.S. government-sponsored enterprise debt securities. Because the sum of the permitted allocation for corporate bonds and government-sponsored enterprise debt securities totals 100 percent, the institution cannot use the zero percent risk weight for U.S. Treasury securities. However, if the permitted allocation for U.S. government-sponsored enterprise debt securities was 30 percent rather than 40 percent, the institution could risk-weight the remaining 10 percent of the carrying value of its investment at the zero percent risk weight for U.S. Treasuries.

Regardless of the look-through approach an institution employs, the weighted average risk weight for the separate-account policy (excluding any general-account and SVP portions) may not be less than 20 percent, even if all the assets in the separate account would otherwise qualify

for a zero percent risk weight. Furthermore, the portion of the carrying value of the separate-account policy that represents general-account claims on the insurer, such as realizable DAC and mortality reserves, and any portion of the carrying value attributable to an SVP contract, should be risk-weighted at the risk weight applicable to the insurer or the SVP provider, as appropriate.

The following example demonstrates the appropriate risk-weight calculations for the pro rata approach, incorporating the components of a BOLI separate-account policy that includes general-account claims on the insurer as well as the investment allocations permitted for differ-

ent asset classes in the separate-account investment agreement.

*Example.* The separate-account investment agreement requires the account to hold a minimum of 10 percent in U.S. Treasury obligations. It also imposes a maximum allocation of 50 percent in mortgage-backed securities issued by U.S. government-sponsored enterprises, and a maximum allocation of 50 percent in corporate bonds. Assume that the portion of the carrying value of the separate-account policy attributable to realizable DAC and mortality reserves equals \$10 and that the portion attributable to the SVP totals \$10.

Carrying value of separate-account policy	\$100.00
Less: Portion attributable to DAC and mortality reserves	10.00
Portion attributable to SVP	10.00
Net carrying value of separate-account policy available for pro rata	<u>\$ 80.00</u>

#### Risk-weight calculation:

U.S. Treasury @ 10% x \$80 = \$8 x 0% RW	0.00
Corporate bonds @ 50% x \$80 = \$40 x 100% RW	\$ 40.00
GSE MBS @ 40% x \$80 = \$32 x 20% RW	<u>6.40</u>
Separate-account risk-weighted assets subject to pro rata	\$ 46.40
Add back: DAC and mortality reserves = \$10 x 100% RW	\$ 10.00
Add back: SVP = \$10 x 100% RW	<u>10.00</u>
General-account and SVP risk-weighted assets	\$ 20.00
Total BOLI-related risk-weighted assets	<u>\$ 66.40</u>

## Summary

The purchase of BOLI can be an effective way for institutions to manage exposures arising from commitments to provide employee compensation and pre- and post-retirement benefits. Consistent with safe and sound banking practices, institutions must understand the risks associated with this product and implement a risk-management process that provides for the identification and control of such risks. A sound pre-purchase analysis, meaningful ongoing monitoring program, reliable accounting process, and accurate assessment of risk-based capital requirements are all components of the type of risk-

management process the agencies expect institutions to employ.

Where an institution has acquired BOLI in an amount that approaches or exceeds agency concentration levels, examiners will more closely scrutinize the components of the risk-management process and the institution's associated documentation. Where BOLI has been purchased in an impermissible manner, ineffective controls over BOLI risks exist, or a BOLI exposure poses a safety-and-soundness concern, the appropriate agency may take supervisory action, including requiring the institution to divest affected policies, irrespective of tax consequences.

## Appendix A—Common Types of Life Insurance

Life insurance can be categorized into two broad types: temporary (also called “term”) insurance and permanent insurance. There are numerous variations of these products. However, most life insurance policies fall within one (or a combination) of the following categories.

### *Temporary (Term) Insurance*

Temporary (term) insurance provides life insurance protection for a specified time period. Death benefits are payable only if the insured dies during the specified period. If a loss does not occur during the specified term, the policy lapses and provides no further protection. Term insurance premiums do not have a savings component; thus, term insurance does not create cash surrender value (CSV).

### *Permanent Insurance*

In contrast to term insurance, permanent insurance is intended to provide life insurance protection for the entire life of the insured, and its premium structure includes a savings component. Permanent insurance policy premiums typically have two components: the insurance component (e.g., mortality cost, administrative fees, and sales loads) and the savings component. Mortality cost represents the cost imposed on the policyholder by the insurance company to cover the amount of pure insurance protection for which the insurance company is at risk.

The savings component typically is referred to as CSV. The policyholder may use the CSV to make the minimum premium payments necessary to maintain the death benefit protection and may access the CSV by taking out loans or making partial surrenders. If permanent insurance is surrendered before death, surrender charges may be assessed against the CSV. Generally, surrender charges are assessed if the policy is surrendered within the first 10 to 15 years.

Two broad categories of permanent insurance are:

- *Whole life.* A traditional form of permanent insurance designed so that fixed premiums are

paid for the entire life of the insured. Death benefit protection is provided for the entire life of the insured, assuming all premiums are paid.

- *Universal life.* A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a very high CSV. Alternatively, the policyholder can make minimal payments in an amount just large enough to cover mortality and other insurance charges.

### *Purposes for Which Institutions Commonly Purchase Life Insurance*

*Key person.* Institutions often purchase life insurance to protect against the loss of “key persons” whose services are essential to the continuing success of the institution and whose untimely death would be disruptive. For example, an institution may purchase insurance on the life of an employee or director whose death would be of such consequence to the institution as to give it an insurable interest in his or her life. The determination of whether an individual is a key person does not turn on that individual’s status as an officer or director, but on the nature of the individual’s economic contribution to the institution.

The first step in indemnifying an institution against the loss of a key person is to identify the key person. The next and possibly most difficult step is estimating the insurable value of the key person or the potential loss of income or other value that the institution may incur from the untimely death of that person.

Because the most appropriate method for determining the value of a key person is dependent upon individual circumstances, the agencies have not established a formula or a specific process for estimating the value of a key person. Instead, the agencies expect institutions to consider and analyze all relevant factors and use their judgment to make a decision about the value of key persons.

Key-person life insurance should not be used in place of, and does not diminish the need for, adequate management-succession planning. Indeed, if an institution has an adequate management-succession plan, its reliance on a key person should decline as the person gets closer to retirement.

*Financing or cost recovery for benefit plans.* Like other businesses, institutions often use life insurance as a financing or cost-recovery vehicle for pre- and post-retirement employee benefits, such as individual or group life insurance, health insurance, dental insurance, vision insurance, tuition reimbursement, deferred compensation, and pension benefits.

Permanent insurance is used for this purpose. In these arrangements, an institution insures the lives of directors or employees in whom it has an insurable interest to reimburse the institution for the cost of employee benefits. The group of insured individuals may be different from the group that receives benefits. The institution's obligation to provide employee benefits is separate and distinct from the purchase of the life insurance. The life insurance purchased by the institution remains an asset even after the employer's relationship with an insured employee is terminated. The employees who receive benefits, whether insured or not, have no ownership interest in the insurance (other than their general claim against the institution's assets arising from the institution's obligation to provide the stated employee benefits).

There are two common methods of financing employee benefits through the purchase of life insurance. The first is the cost-recovery method, which usually involves present-value analysis. Typically, the institution projects the amount of the expected benefits owed to employees and then discounts this amount to determine the present value of the benefits. Then, the institution purchases a sufficient amount of life insurance on the lives of certain employees so that the gain (present value of the life insurance proceeds less the premium payments) from the insurance proceeds reimburses the institution for the benefit payments. Under this method, the institution absorbs the cost of providing the employee benefits and the cost of purchasing the life insurance. The institution holds the life insurance and collects the death benefit to reimburse the institution for the cost of the employee benefits and the insurance.

The second method of financing employee benefits is known as cost offset. With this method, the institution projects the annual employee benefit expense associated with the benefit plan. Then, the institution purchases life insurance on the lives of certain employees. The amount earned on the CSV each year should not exceed the annual benefit expense.

*Split-dollar life insurance arrangements.* Institutions sometimes use split-dollar life insurance arrangements to provide retirement benefits and death benefits to certain employees as part of their compensation. Under split-dollar arrangements, the employer and the employee share the rights to the policy's CSV and death benefits. The employer and the employee may also share premium payments. If the employer pays the entire premium, the employee may need to recognize taxable income each year in accordance with federal income tax regulations.

Split-dollar arrangements may be structured in a number of ways. The two most common types of split-dollar arrangements are:

- *Endorsement split-dollar.* The employer owns the policy and controls all rights of ownership. The employer provides the employee an endorsement of the portion of the death benefit specified in the plan agreement with the employee. The employee may designate a beneficiary for the designated portion of the death benefit. Under this arrangement, the employer typically holds the policy until the employee's death. At that time, the employee's beneficiary receives the designated portion of the death benefits, and the employer receives the remainder of the death benefits.
- *Collateral-assignment split-dollar.* The employee owns the policy and controls all rights of ownership. Under these arrangements, the employer usually pays the entire premium or a substantial part of the premium. The employee assigns a collateral interest in the policy to the employer that is equal to the employer's interest in the policy. The employer's interest in the policy is set forth in the split-dollar agreement between the employer and the employee. Upon retirement, the employee may have an option to buy the employer's interest in the insurance policy. This transfer of the employer's interest to the employee is typically referred to as a "roll-out." If a "roll-out" is not provided or exercised, the employer does not receive its interest in the policy until the employee's death.

Split-dollar life insurance is a very complex subject that can have unforeseen tax and legal consequences. Internal Revenue Service regulations issued in 2003<sup>14</sup> govern the taxation of

14. 68 *Fed. Reg.* 54336 (Sept. 17, 2003), chiefly codified at 26 CFR 1.61-22 and 1.7872-15.

split-dollar life insurance arrangements entered into or materially modified after September 17, 2003.<sup>15</sup> These rules provide less favorable tax treatment to split-dollar arrangements than existed previously. Institutions considering entering into a split-dollar life insurance arrangement should consult qualified tax, insurance, and legal advisers.

*Life insurance on borrowers.* State law generally recognizes that a lender has an insurable interest in the life of a borrower to the extent of the borrower's obligation to the lender. In some states, the lender's insurable interest may equal the borrower's obligation plus the cost of insurance and the time value of money. Institutions are permitted to protect themselves against the risk of loss from the death of a borrower. This protection may be provided through self-insurance, the purchase of debt-cancellation contracts, or by the purchase of life insurance policies on borrowers.

Institutions can take two approaches in purchasing life insurance on borrowers. First, an institution can purchase life insurance on an individual borrower for the purpose of protecting the institution specifically against loss arising from that borrower's death. Second, an institution may purchase life insurance on borrowers in a homogeneous group of loans employing a cost-recovery technique similar to that used in conjunction with employee benefit plans. Under this method, the institution insures the group of borrowers for the purpose of protecting the institution from loss arising from the death of any borrower in the homogeneous pool. Examples of homogeneous pools of loans include consumer loans that have distinctly similar characteristics, such as automobile loans, credit card loans, and residential real estate mortgages.

When purchasing insurance on an individual borrower, an institution should, given the facts and circumstances known at the time of the insurance purchase, make a reasonable effort to structure the insurance policy in a manner consistent with the expected repayment of the borrower's loan. To accomplish this, management should estimate the risk of loss over the life of the loan and match the anticipated insurance proceeds to the risk of loss. Generally, the risk of loss will be closely related to the out-

standing principal of the debt. The insurance policy should be structured so that the expected insurance proceeds never substantially exceed the risk of loss.

When purchasing life insurance on borrowers in a homogeneous pool of loans, an institution's management should, given the facts and circumstances known at the time of the insurance purchase, make a reasonable effort to match the insurance proceeds on an aggregate basis to the total outstanding loan balances. If allowed by state law, institutions may match the insurance proceeds to the outstanding loan balances plus the cost of insurance on either a present-value or future-value basis. This relationship should be maintained throughout the duration of the program.

The purchase of life insurance on a borrower is not an appropriate mechanism for effecting a recovery on an obligation that has been charged off, or is expected to be charged off, for reasons other than the borrower's death. In the case of a charged-off loan, the purchase of life insurance on the borrower does not protect the institution from a risk of loss since the loss has already occurred. Therefore, the institution does not need to purchase insurance. Acquiring insurance that an institution does not need may subject the institution to unwarranted risks, which would be an unsafe and unsound banking practice. In the case of a loan that the institution expects to charge off for reasons other than the borrower's death, the risk of loss is so pronounced that the purchase of life insurance by the institution at that time would be purely speculative and an unsafe and unsound banking practice.

Internal Revenue Code section 264(f) disallows a portion of an institution's interest deduction for debt incurred to purchase life insurance on borrowers. Institutions considering the purchase of insurance on borrowers should consult their tax advisers to determine the economic viability of this strategy.

*Life insurance as security for loans.* Institutions sometimes take an interest in an existing life insurance policy as security for a loan. Institutions also make loans to individuals to purchase life insurance, taking a security interest in the policy, a practice known as "insurance-premium financing." As with any other type of lending, extensions of credit secured by life insurance should be made on terms that are consistent with safe and sound banking practices. For instance, the borrower should be obligated to repay the

15. Split-dollar arrangements entered into prior to September 17, 2003, and not materially modified thereafter may be treated differently.



loan according to an appropriate amortization schedule.

Generally, an institution may not rely on its security interest in a life insurance policy to extend credit on terms that excuse the borrower from making interest and principal payments during the life of the borrower with the result that the institution is repaid only when the policy matures upon the death of the insured. Lending on such terms is generally speculative and an unsafe and unsound banking practice.

Institutions may acquire ownership of life insurance policies for debts previously contracted (DPC) by invoking their security interest in a policy after a borrower defaults. Consistent with safety and soundness, institutions should use their best efforts to surrender or otherwise dispose of permanent life insurance acquired for DPC at the earliest reasonable opportunity.<sup>16</sup> In the case of temporary insurance acquired for DPC, retention until the next renewal date or the next premium date, whichever comes first, will be considered reasonable.

## Appendix B—Glossary

*Cash surrender value (CSV).* The value available to the policyholder if the policy is surrendered. If no loans are outstanding, this amount is generally available in cash. If loans have been made, the amount available upon surrender is equal to the cash surrender value less the outstanding loan (including accrued interest).

*Deferred acquisition costs (DAC).* DAC represents the insurance carrier's up-front costs associated with issuing an insurance policy, including taxes and commissions and fees paid to agents for selling the policy. The carrier charges the policyholder for these costs. Carriers capitalize DAC and recover them in accordance with applicable tax law. As the carrier recovers DAC, it credits the amount to the policyholder.

*Experience-rated pricing.* A pricing method that bases prices for insurance products on the actual expenses and claims experience for the pool of individuals being insured.

*General account.* A design feature that is gen-

erally available to purchasers of whole or universal life insurance whereby the general assets of the insurance company support the policy's CSV.

*Interest-crediting rate.* The gross yield on the investment in the insurance policy, that is, the rate at which the cash value increases before considering any deductions for mortality cost, load charges, or other costs that are periodically charged against the policy's cash value.

There are a number of crediting rates, including "new money" and "portfolio." Using the "portfolio" crediting rate, the institution will earn a return based upon the existing yield of the insurance carrier's portfolio each year. Using the "new money" crediting rate, the institution will earn a return based upon yields available in the market at the time it purchases the policy.

*Modified endowment contract (MEC).* Type of policy that is defined in Internal Revenue Code section 7702A. A MEC generally involves the payment of a single premium at the inception of the contract; thus, it fails the so-called seven-pay test set forth in the statute. MECs are denied some of the favorable tax treatment usually accorded to life insurance. For example, most distributions, including loans, are treated as taxable income. An additional 10 percent penalty tax also is imposed on distributions in some circumstances. However, death benefits remain tax-free.

*Mortality charge.* The pure cost of the life insurance death benefit within a policy. It represents a cost to the purchaser and an income item to the carrier. Mortality charges retained by the insurance carrier are used to pay claims.

*Mortality reserve.* In separate-account products, the mortality reserve represents funds held by an insurance carrier outside of the separate account to provide for the payment of death benefits.

*Non-MEC.* An insurance contract that is not categorized as a MEC under Internal Revenue Code section 7702A.

*Separate account.* A separate account is a design feature that is generally available to purchasers of whole life or universal life whereby the policyholder's CSV is supported by assets segregated from the general assets of the carrier. Under such an arrangement, the policyholder

<sup>16</sup> The OCC has generally directed national banks to surrender or divest permanent life insurance acquired for DPC within 90 days of obtaining control of the policy.



neither owns the underlying separate account nor controls investment decisions (e.g., timing of investments or credit selection) in the underlying separate account that is created by the insurance carrier on its behalf. Nevertheless, the policyholder assumes all investment and price risk.

*Seven-pay test.* The seven-pay test is a test set forth in Internal Revenue Code section 7702A that determines whether or not a life insurance product is a MEC for federal tax purposes.

*Split-dollar life insurance.* A split-dollar life insurance arrangement splits the policy's premium and policy benefits between two parties, usually an employer and employee. The two parties may share the premium costs while the policy is in effect, pursuant to a prearranged contractual agreement. At the death of the insured or the termination of the agreement, the parties split the policy benefits or proceeds in accordance with their agreement.

*Stable value protection (SVP) contracts.* In general, an SVP contract pays the policy owner of a separate account any shortfall between the fair value of the separate-account assets when the policy owner surrenders the policy and the cost basis of the separate account to the policy owner. The cost basis of the separate account typically would take into account the fair value of the assets in the account when the policy was initially purchased, the initial fair value of assets added to the account thereafter, interest credited to the account, the amount of certain redemptions and withdrawals from the account, and credit losses incurred on separate-account assets. Thus, SVP contracts mitigate price risk. SVP contracts are most often used in connection with fixed-income investments.

*1035 exchange.* A tax-free replacement of an insurance policy for another contract covering the same person(s) in accordance with section 1035 of the Internal Revenue Code.

*Variable life insurance.* Variable life insurance policies are investment-oriented life insurance policies that provide a return linked to an underlying portfolio of securities. The portfolio typically is a group of mutual funds chosen by the insurer and housed in a separate account, with the policyholder given some discretion in choosing among the available investment options.

## Appendix C—Interagency Interpretations of the Interagency Statement on the Purchase and Risk Management of Life Insurance

The federal banking and thrift agencies developed responses to questions regarding the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance. A summary of these interpretations is included below to provide clarification on a wide variety of matters pertaining to financial reporting, credit-exposure limits, concentration limits, and the appropriate methodologies to use for calculating the amount of insurance an institution may purchase.

### *Legal Authority—State and Federal Law*

As a general matter, the ability of state-chartered banks to purchase insurance (including equity-linked variable life insurance) is governed by state law. Section 24 of the Federal Deposit Insurance Act (the FDI Act) generally requires insured state-chartered banks to obtain the consent of the Federal Deposit Insurance Corporation (FDIC) before engaging as principal in activities (including making investments) that are not permissible for a national bank. Some state bank regulatory agencies have issued their own BOLI guidance or directives for their respective state-chartered institutions. A state-chartered institution should follow any BOLI guidance or directive issued by its state supervisory authority that is more restrictive than the interagency statement. Generally, if state law or policy is less restrictive than the interagency statement, a state-chartered institution should follow the interagency statement. If federal law is less restrictive than state law, a state-chartered institution should follow the state law.

### *Permissibility of Equity-Linked Securities in Separate-Account BOLI*

The interagency statement states that national banks and federal savings associations may hold equity-linked variable life insurance policies (that is, insurance policies with a return tied to the performance of a portfolio of equity securities held in a separate account of the insurance company) only in very limited circumstances.

Similarly, state member banks may also hold equity-linked variable life insurance policies only in very limited circumstances. Because the range of instruments with equity-like characteristics varies significantly, the permissibility of each such instrument must be analyzed on a case-by-case basis. Furthermore, the agencies have significant concerns regarding whether an institution properly understands the complex risk profile that securities with “equity-like” characteristics often present. Some securities, even if legally permissible, may be inappropriate for the vast majority of financial institutions, whether held in an investment portfolio or a separate-account BOLI product. The agencies’ April 1998 Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities provides guidance on the appropriateness of investments and risk-management expectations.

### *Senior Management and Board Oversight—Establishing BOLI Concentration Limits*

Each institution should establish internal policies and procedures governing its BOLI holdings that limit the aggregate cash surrender value (CSV) of policies from any one insurance company as well as the aggregate CSV of policies from all insurance companies. The inter-agency statement is not intended to loosen the standards with respect to prior BOLI guidance. The agencies have rigorous expectations regarding the establishment of prudent limits and appropriate board and management oversight of the limit-setting process. Accordingly, exceptions will be subject to increased supervisory attention. The agencies continue to expect institutions to adopt per-carrier limits for BOLI, keeping in mind legal lending limits. Although the federal statutory and regulatory lending limits do not, as a general rule, impose a per-carrier legal constraint on BOLI because BOLI is not a loan, BOLI nevertheless does represent a long-term credit exposure. The agencies expect institutions to manage credit exposures in a prudent manner, irrespective of whether the exposure is subject to a statutory or regulatory limit. If an institution establishes an aggregate limit for BOLI based upon its applicable capital concentration threshold, it would seldom be prudent to have its per-carrier limit equal to the aggregate limit. Apart from credit

considerations, it is also important to diversify BOLI exposures in order to control transaction risks that may be associated with an individual carrier’s policies.

### *Per-Carrier Limits*

Institutions should establish a per-carrier limit for separate-account policies. Diversification among carriers reduces transaction risks. Institutions should also explicitly consider whether it is appropriate to combine general- and separate-account exposures from the same carrier for purposes of measuring exposure against internal limits. The agencies believe that institutions, based upon their risk tolerance and understanding of insurance risks, should determine for themselves whether to combine such policies. In this regard, the agencies note that separate-account policies also present general-account credit exposures. For example, deferred acquisition costs (DAC) and mortality reserves associated with separate-account policies are general obligations of the insurance carrier. Moreover, when the death of an insured occurs, the difference between the death benefit amount and the cash surrender value comes from the carrier’s general account. Finally, the actual credit exposure under a BOLI policy may be many times greater than the carrying value of the policy currently recorded on the institution’s balance sheet, given the typical relationship between CSV and policy death benefits. Institutions should keep these factors in mind when evaluating whether and, if so, how to aggregate general- and separate-account exposures for purposes of monitoring compliance with internal limits.

### *Legal Limits and Concentrations*

When establishing internal CSV limits, an institution should consider its legal lending limit, the capital concentration thresholds, and any applicable state restrictions on BOLI holdings. The following are the agencies’ capital concentration definitions:

- The FDIC uses 25 percent of tier 1 capital to measure a capital concentration.
- The other agencies use tier 1 capital plus the allowance for loan and lease losses (ALLL).

A state-chartered institution should be guided by the more restrictive of the applicable state and federal limitations and thresholds. For example, if a state defines BOLI as an extension of credit subject to a statutory or regulatory lending limit, or otherwise imposes a per-carrier limit on BOLI, then institutions subject to that state's jurisdiction should ensure that their BOLI exposure to an individual carrier does not exceed the applicable state limit.

### *Permissibility of Holding Life Insurance on Former Employees and Former Key Persons*

A well-managed institution adequately documents the purpose for which it is acquiring BOLI, as part of its pre-purchase analysis. When an institution purchases life insurance on a group of employees (whether it is a group policy or a series of individual policies) as a means to finance or recover the cost of employee benefits, and one or more of the insured employees is no longer employed by the bank, the insurance coverage may be retained by the institution provided—

- the application of the cost-recovery or cost-offset method (see “Quantifying the Amount of Insurance Appropriate for the Institution’s Objectives” below) indicates that the amount of insurance held is not in excess of the amount required to recover or offset the cost of the institution’s employee benefits,
- the policy is not specifically designated to cover only loss of income to the banking organization that may arise from the death of the employee,
- the coverage continues to qualify as an insurable interest under applicable state law, and
- the insurance asset continues to be a permissible holding under applicable state law for state-chartered institutions.

Additionally, if the policy no longer qualifies as insurance under the applicable state insurable-interest law, the policy may no longer be eligible for favorable tax treatment. These conditions apply to “benefits BOLI” despite the fact that the former employee was a “key person.”

This is in contrast to true key-person insurance, in which the institution purchases life insurance on a key person in order to protect itself from financial loss in the event of that

person’s death. The interagency statement provides that a national bank or federal savings association may be required to surrender or otherwise dispose of key-person life insurance held on an individual who is no longer a key person because the institution will no longer suffer a financial loss from the death of that person. However, when an individual upon whom key-person life insurance has been held is no longer a key person, an institution may be able to recharacterize its objective for the insurance policy as recovery of the cost of providing employee benefits. In such cases, the institution must demonstrate, through appropriate analysis and quantification, that the insurance coverage satisfies the retention conditions, as set forth in the preceding paragraph. For a state-chartered institution, the recharacterization and retention of such key-person life insurance must be permissible under applicable state law. In circumstances where a national bank or federal savings association would be required to surrender or otherwise dispose of key-person life insurance, a state-chartered institution must also surrender or otherwise dispose of a key-person policy unless the retention of the policy is permitted under applicable state law and the institution obtains the FDIC’s consent to continue to hold the policy under section 24 or section 28 of the FDI Act, as appropriate.

### *Quantifying the Amount of Insurance Appropriate for the Institution’s Objectives*

Institutions are responsible for ensuring that they do not purchase excessive amounts of insurance coverage on their employees relative to salaries paid and the costs of benefits to recover. Examiners will evaluate an institution’s BOLI holdings and make a supervisory judgment as to whether insurance amounts on employees are so excessive as to constitute speculation or an unsafe or unsound practice on a case-by-case basis, as they do for other aspects of an institution’s operations. Such an evaluation would be based on the totality of the circumstances.

Institutions may use either the cost-recovery or cost-offset method to quantify the amount of insurance permissible for purchase to finance or recover employee benefit costs. When using the cost-offset approach, an institution must ensure that the projected increase in CSV each year

over the expected duration of the BOLI is less than or equal to the expected employee benefit expense for that year. When using the cost-recovery method, regardless of an institution's quantification method, management must be able to support, with objective evidence, the reasonableness of all assumptions used in determining the appropriate amount of insurance coverage needed, including the rationale for its discount rates (when the cost-recovery method is used) and cost projections.

### *Applicability of Prior Guidance for Split-Dollar Arrangements*

The pre-purchase analysis guidance in the interagency statement applies to life insurance policies used in split-dollar arrangements that are acquired after December 7, 2004. The guidance concerning the ongoing risk management of life insurance after its purchase applies to life insurance policies, including those used in split-dollar arrangements, regardless of when acquired.

The FDIC's prior guidance on split-dollar arrangements, which was included in supervisory guidance on BOLI that was issued in 1993, has been superseded; until the issuance of the interagency statement, the FDIC had generally followed the Office of the Comptroller of the Currency's prior guidelines from 2000. Otherwise, the prior guidance issued by the agencies on split-dollar life insurance remains in effect. Each agency issued the interagency statement under its own bulletin, letter, or notice. For example, the Federal Reserve Board's issuance of the interagency statement is cross-referenced in SR-04-19, and the prior guidance on split-dollar life insurance arrangements is not superseded.

### *Accounting Considerations*

An institution may purchase multiple permanent insurance policies from the same insurance carrier, with each policy having its own surrender charges. In some cases, the insurance carrier will issue a rider or other contractual provision stating that it will waive the surrender charges if all of the policies are surrendered at the same time. Because it is not known at any balance-sheet date whether one or more of the policies will be surrendered before the deaths of the insureds, the possibility that the institution will

surrender all of these policies simultaneously and avoid the surrender charges is a gain contingency. This guidance should be applied to all insurance policies held by an institution regardless of when they were acquired. Therefore, an institution that has purchased BOLI is required to report the CSV on the bank's balance sheet net of the surrender charges (even if the policies have been in force for some time and the institution's auditors have not previously required reporting the CSV net of the surrender charges).

Based on the agencies' review of FASB Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance" (TB 85-4), including its appendix, the agencies believe that TB 85-4 is intended to be applied on a policy-by-policy basis. It, therefore, does not permit the aggregation of multiple separate policies for balance-sheet-measurement purposes. Accordingly, the agencies do not intend to defer to institutions or their auditors on this issue. As of the balance-sheet date, an institution should determine the amount that could be realized under each separate insurance policy on a stand-alone basis without regard to the existence of other insurance policies or riders covering multiple policies. If a single insurance policy covers more than one individual, the realizable amount of the entire policy should be determined. A single insurance policy covering multiple individuals should not be subdivided into hypothetical separate policies for each covered individual, even if the carrier reports CSVs for each covered individual.

If a change in an institution's accounting for its holdings of life insurance is necessary for regulatory reporting purposes, the institution should follow Accounting Principles Board Opinion No. 20, "Accounting Changes" (APB 20).<sup>17</sup> APB 20 defines various types of accounting changes and addresses the reporting of corrections of errors in previously issued financial statements. APB 20 states that "[e]rrors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared."

17. Effective December 15, 2005, APB 20 will be replaced by FASB Statement No. 154, "Accounting Changes and Error Corrections—A replacement of APB Opinion No. 20 and FASB Statement No. 3."

For regulatory reporting purposes, an institution must determine whether the reason for a change in its accounting for its holdings of life insurance meets the APB 20 definition of an accounting error. If the reason for the change meets this definition and the amount is material, the error should be reported as a prior-period adjustment in the institution's regulatory reports. Otherwise, the effect of the correction of the error should be reported in current earnings. If the effect of the correction of the error is material, the institution should also consult with its primary federal regulatory agency to determine whether any previously filed regulatory reports should be amended. For the Call Report, the institution should report the amount of the adjustment in Schedule RI-A, item 2, "Restatements due to corrections of material accounting errors and changes in accounting principles," with an explanation in Schedule RI-E, item 4. The effect of the correction of the error on income and expenses since the beginning of the period in which the correction of prior-period earnings is reported should be reflected in each affected income and expense account on a year-to-date basis in the Call Report Income Statement (Schedule RI), not as a direct adjustment to retained earnings.

### *Rate of Return to the Bank in Split-Dollar Insurance Arrangements*

The agencies would consider the institution's economic interest in a split-dollar life insurance arrangement policy, at a minimum, to be a return of the premiums paid plus a reasonable rate of return. The agencies would generally consider a reasonable rate of return to be one that provides the bank a return that is commensurate with alternative investments having similar risk characteristics (including credit quality and term) at the time in which the bank enters into the split-dollar arrangement. The rate of return is to be calculated net of any payments made (or to be made) from insurance proceeds to the employee's beneficiaries.

The agencies look at the economic value of compensation arrangements when determining the reasonableness of split-dollar compensation, but the agencies do not rely solely on income tax rules for determining this economic value. Other factors that the agencies might consider include, but are not limited to, the benefit of a split-dollar arrangement to the employee as a percentage of salary and the expected length of time until the institution recovers its invested funds.

# Purchase and Risk Management of Life Insurance

## Examination Objectives

Effective date November 2005

## Section 4042.2

1. To determine the level and direction of risk that purchases and holdings of life insurance pose to the state member bank, and to recommend corrective action, as appropriate.
2. To perform—
  - a. a risk assessment that summarizes the level of inherent risk by risk category, and
  - b. an assessment of the adequacy of the board of directors' and management's oversight of the activity, including an assessment of the bank's internal control framework.
3. To ensure that the risk assessment considers a state member bank's purchase and risk management of its—
  - a. broad bank-owned life insurance (BOLI) programs, in which life insurance is purchased on a group of employees to offset employee benefit programs and the bank is the beneficiary;
  - b. split-dollar insurance arrangements for individual (usually senior-level) bank employees; and
  - c. holdings of key-person insurance.
4. Recognizing that management may not be as familiar with insurance products as it is with more-traditional bank products, to adequately identify and assess the risks of BOLI, as well as the risk exposures that may arise from purchases and holdings of life insurance.<sup>1</sup>
5. To apply a forward-looking approach to the review of a bank's purchase and risk management of life insurance, recognizing that the bank may be exposed to increasing operational risks as a result of its large purchases or holdings of this product. These risks may arise from—
  - a. separate-account assets that contain holdings of complex equity-linked notes and derivative products;
  - b. the growing use of guaranteed minimum death benefits and other complex guarantee structures, which may increase the operational risk to banks purchasing significant amounts of life insurance; and
  - c. the potential losses that could result from—
    - inadequate recordkeeping, which may be related to tracking the potentially large variety of contracts and agreements and the potentially large number of insured current and former employees covered by the contracts, and
    - a failure to ensure that contract agreements between the insurance company, the vendor(s), and the employees are properly executed and honored.

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1. As noted in more depth in section 4042.1, the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance, these risks include opera-

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tional, liquidity, credit, legal, and reputational risk. Operational risk arises in part from the vast array of new life insurance products and structures being offered and from the complexity of tax considerations related to the products, under various state insurable-interest and federal tax laws.

# Purchase and Risk Management of Life Insurance

## Examination Procedures

Effective date May 2006

## Section 4042.3

### PRELIMINARY RISK ASSESSMENT

1. Consider the following, among other relevant criteria as appropriate, when determining whether to include the review of bank-owned life insurance (BOLI) in the examination scope:
  - a. the volume, growth, and complexity of BOLI purchases and holdings
    - Consider the amount of the bank's BOLI holdings, measured by the total of their cash surrender values (CSVs) as a percentage of capital, and determine whether the resulting percentage is an asset concentration of capital. (For state member banks, the Federal Reserve has defined the capital base for determining this concentration threshold to be a percentage of tier 1 capital plus the allowance for loan and lease losses.) Determine whether the BOLI holdings have grown or declined significantly in recent years, when compared with the BOLI holdings of peer banks (consult the Federal Reserve System's intranet for applicable surveillance and monitoring data).
    - Obtain a breakout of the CSV of BOLI assets, as reported on the bank's balance sheet, including the amounts attributable to split-dollar insurance arrangements, general BOLI plans covering a group of employees to recover the cost of employee compensation and benefit programs, and the amount, if any, attributable to key-person insurance.
    - Obtain a listing of the amount of the bank's reimbursable premium payments under split-dollar life insurance arrangements and the amount receivable for these policies, which is to be booked as "other assets" on the bank's balance sheet.
    - Determine whether a portion of the CSV is in separate-account holdings of a life insurance company. If the bank has separate-account holdings, determine (1) the composition of the underlying separate-account assets and (2) if these assets constitute higher-risk investments, including equity-linked notes, mortgage-backed securities with significant interest-rate risk, or other investments entailing significant market risk.
  - b. BOLI concentrations
    - Determine whether any of the life insurance policies are held in out-of-state trusts. If so, ascertain—
      - whether management and the board of directors can demonstrate that they have performed an independent legal analysis to ensure that the legal structure employed does not jeopardize the bank's insurable interest in the insurance policies or its access to the policy proceeds, as applicable; and
      - whether the trust arrangement inappropriately disadvantages the bank (for example, by permitting inappropriate investments or permitting the insured or the beneficiary to borrow against the policy holding in such a way that could jeopardize the bank's ability to recover amounts owed to it under the trust agreement).
    - Determine if there is a CSV concentration of life insurance to one carrier in excess of 25 percent that includes both separate-account and general-account BOLI holdings.
    - Determine if there are any market-risk concentrations within the underlying separate-account assets, including, for example, interest-sensitive fixed-income holdings.
    - Determine if there are any equity-linked notes or direct equity holdings in the separate accounts.
    - Determine if the bank holds any large-exposure life insurance policies on particular individuals. If so, determine if the policies are split-dollar arrangements and, if so—
      - whether the board or a board committee has evaluated the rea-

- sonableness of the compensation as part of the employee's overall compensation package, and
- whether the board or a board committee has determined that the overall compensation is appropriate.
- c. the appropriateness and recency of materials presented to the bank's board of directors concerning the bank's purchase and risk management of life insurance relative to its insurance purchases and holdings
  - d. the appropriateness and recency of audits and compliance reviews of the bank's purchases and risk management of life insurance
  - e. the overall financial condition of the bank, its supervisory rating, and any concerns or potential concerns about its liquidity
2. Depending upon the outcome of the preliminary risk assessment and other relevant factors, consider performing the following examination procedures.

## OPERATIONAL-RISK ASSESSMENT

### Senior Management and Board Oversight

1. Evaluate whether board and senior management oversight is effective and ensures that the bank's purchases and holdings of BOLI are consistent with safe and sound banking practices.
2. Determine whether the board of directors understands the complex risk characteristics of the bank's insurance holdings and the role of BOLI in the bank's overall business strategy.

### Accounting Considerations

3. Determine if the bank's financial and regulatory reporting of its life insurance activities follows applicable generally accepted accounting principles (GAAP), including the following guidance:
  - a. *Financial Accounting Standards Board (FASB) Technical Bulletin No. 85-4*,

*“Accounting for Purchases of Life Insurance” (TB 85-4)*. Only the amount that can be realized under an insurance contract as of the balance-sheet date (that is, the CSV reported to the bank by the insurance carrier, less any applicable surrender charges not reflected by the insurance carrier in the reported CSV) is reported as an asset. Since there is no right of offset, a BOLI investment is reported as an asset separately from any deferred compensation liability, provided that it was not purchased in connection with a tax-qualified plan.

- b. *Call Report instructions*. The bank is required to report the carrying value of its BOLI holdings (CSV net of applicable surrender charges) as a component of “other assets” and to report the earnings on these holdings as “other noninterest income.”
4. Verify that the bank's deferred compensation agreements were accounted for using the guidance in the February 11, 2004, Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance.
  5. Verify that any accounts receivable that represent the bank's reimbursable life insurance premiums paid are recorded as unimpaired account receivables (for example, life insurance policies that are not impaired as a result of declining CSVs backing the obligations or employees borrowing against CSVs). (Impaired amounts should be expensed.)

### Policies and Procedures

6. Assess the adequacy of the bank's policies and procedures governing its BOLI purchases and holdings, including its guidelines to limit the aggregate CSV of policies from one insurance company as well as limit the aggregate CSV of policies from all insurance companies.
7. Verify if the bank's board of directors or the board's designated committee approved BOLI purchases in excess of 25 percent of capital or in excess of any lower internal limit. (For state member banks, the Federal Reserve has defined the capital base for determining this concentration threshold to be a percentage of tier 1 capital plus the



allowance for loan and lease losses.)

8. Determine the reasonableness of the bank's internal limits and whether management and the board of directors have considered, before purchasing BOLI, the bank's legal lending limit, its applicable state and federal capital concentration threshold, and any other applicable state restrictions on BOLI.
9. For banks that may have other credit exposures to insurance companies, determine if the bank has considered the credit exposures arising from its BOLI purchases when assessing its overall credit exposure to a carrier and to the insurance industry.
10. Determine whether the bank's management has justified and analyzed the risks associated with a significant increase in the bank's BOLI holdings.
11. Determine if the bank has advised its board of directors of the existence of the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance and of the risks associated with BOLI.

### Pre-Purchase Analysis

12. Ascertain whether the bank maintains adequate records of its pre-purchase analysis of BOLI.
13. Evaluate whether the bank's board of directors, or a designated board committee, and senior management understand the risks, rewards, and unique characteristics of BOLI.

### *Need for Insurance, Economic Benefits, and Appropriate Insurance Type*

14. Determine whether the bank identified the specific risk of loss to which it is exposed or the specific costs to be recovered by the purchase of life insurance.
15. Determine whether the bank analyzed the costs and benefits of planned BOLI purchases.

### *Amount of Insurance Appropriate for the Institution's Objectives*

16. Find out if the bank estimated the size of its employee benefit obligation or the risk of

loss to be covered in order to ensure that the amount of BOLI purchased was not excessive in relation to this estimate and the associated product risks.

17. Determine whether management can support, with objective evidence, the reasonableness of all of the assumptions used in determining the appropriate amount of insurance coverage needed by the bank, including the rationale for its discount rates and cost projections.

### *Vendor Qualifications*

18. Evaluate whether the bank's management assessed its own knowledge of insurance risks, the vendor's qualifications, the amount of resources the bank is willing to spend to administer and service the BOLI, and the vendor's ability to honor the long-term financial commitments associated with BOLI.

### *Characteristics of Available Insurance Products*

19. Evaluate whether the bank's management has reviewed and understands the characteristics of the various life insurance products available and of the products it has acquired.
20. Ascertain if and how the bank's management reviewed and selected the life insurance product characteristics that best matched its objectives, needs, and risk tolerance. Ascertain whether management evaluated and documented, before the bank acquired BOLI, the risks of the variety and complexity of life insurance products considered, how the selected insurance product works, the variables that affect the product's performance, and the applicable tax and accounting treatments.
21. Determine whether the bank's management reviewed and documented its consideration of the types and design features of BOLI. Determine whether management reviewed and documented the negotiable features associated with a separate-account insurance product (for example, its investment options, terms, and conditions; the cost of stable value protection (SVP); deferred acquisition costs (DAC); and mortality options) and with any SVP provider that

may have been separately contracted by the insurance carrier.

22. Verify that the bank's management conducted a thorough review of life insurance policies before acquiring the policies. Ascertain if management determined how the accounting rules would apply to those policies and if it understood any ambiguous contract provisions, such as costs, charges, or reserves, that may affect the amount of a policy's CSV.

### *Tax and Insurable-Interest Implications*

23. For the bank's pre-acquisition review of BOLI and its subsequent BOLI purchases, verify that the bank's management considered and documented its analysis of the financial impact of surrendering a policy (for example, any tax implications).
24. Verify that the bank's management obtained appropriate legal reviews. An appropriate legal review ensures that—
  - a. the bank complies with applicable tax and state insurable-interest requirements, and
  - b. the bank's insured amounts are *not* excessive (therefore, the bank is not involved in impermissible speculation or unsafe and unsound banking practices).

### *Carrier Selection*

25. Find out if the bank (1) reviewed the BOLI product's design and pricing and the administrative services of the proposed carrier and (2) compared these services with those of other insurance carriers.
26. Ascertain whether the bank's management reviewed the selected carrier's ongoing long-term ability to commit to the BOLI product, as well as its credit ratings, general reputation, experience in the marketplace, and past performance.
27. Determine if the bank performed a credit analysis on the selected BOLI carriers and if the analysis was consistent with safe and sound banking practices for commercial lending.

### *Split-Dollar or Other Insurance Arrangements That Result in Additional Insured Employee Compensation*

28. When a bank acquires insurance that permits a bank officer or employee to designate a beneficiary or provides the officer or employee with additional compensation, determine if the bank identified and quantified its total compensation objective. Determine if the bank ensured (1) that the acquired split-dollar life or other insurance arrangement was consistent with that objective, including when insurance compensation is combined with all other compensation being provided, and (2) that the total compensation was not excessive.
29. Verify that the bank and the insured have entered into a written agreement that specifically states the bank's rights, the insured individual's rights, and the rights of any other parties (trusts or beneficiaries) to the policy's CSV and death benefits.
30. Verify that the bank's shareholders and their family members (who are not bank officers, directors, or employees and who do not provide goods and services to the bank) do not receive compensation in the form of split-dollar life or other insurance coverage benefits.
31. Determine whether the bank's management has assessed the bank's ability to borrow against the CSV of its split-dollar life insurance policies, as well as the ability of other parties (whether an insured officer, employee, or noninstitution owner) to borrow against the policy CSV, without impairing the bank's financial interest in the policy proceeds. Determine also—
  - a. if the bank can liquidate the policy in order to meet liquidity needs; or
  - b. if the bank effects an early policy surrender (such as might occur if an employee terminates his or her employment), if the surrender would preclude the bank from recovering its premium payments and a market rate of return on the premiums invested.
32. Determine if and how management verified that the bank would be able to recover its premium payments plus a market rate of return on the premiums invested, after the payment of policy proceeds to the employee's beneficiary under the split-dollar arrangement.

*Other Elements of Pre-Purchase Analysis*

33. Ascertain whether the bank's management thoroughly evaluated all significant risks. Determine whether management has established procedures to identify, measure, monitor, and control those risks.
34. Find out if the bank, before acquiring BOLI, thoroughly analyzed its associated risks and benefits. As appropriate, determine whether the bank compared the risks of BOLI with those of alternative methods for recovering costs associated with the loss of key persons, providing pre- and post-retirement employee benefits, or providing additional employee compensation.

**Post-Purchase Analysis**

35. Find out if management reviewed at least annually the bank's life insurance purchases and holdings with the bank's board of directors.<sup>1</sup> Ascertain if the review included, at a minimum—
  - a. a comprehensive assessment of the specific risks associated with the bank's permanent insurance acquisitions;
  - b. an identification of the bank's employees who are or will be insured (for example, vice presidents and above, employees of a certain grade level, etc.);
  - c. an assessment of death benefit amounts relative to employee salaries;
  - d. a calculation of the percentage of insured persons still employed by the bank;
  - e. an evaluation of the material changes to BOLI risk-management policies;
  - f. an assessment of the effects of policy exchanges;
  - g. an analysis of mortality performance and the impact on income;
  - h. an evaluation of material findings from internal and external audits and independent risk-management reviews;
  - i. an identification of the reason for, and the tax implications of, any policy surrenders; and

1. More-frequent reviews should be conducted if significant changes to the BOLI program are anticipated, such as additional purchases, a decline in the financial condition of the insurance carrier(s), anticipated policy surrenders, or changes in tax laws or interpretations that could have an impact on the performance of BOLI.

- j. a peer analysis of BOLI holdings.

**LIQUIDITY-RISK ASSESSMENT**

1. Find out if management, before the bank's purchase of permanent insurance, recognized the illiquid nature of the bank's acquisition of its permanent insurance products. Determine whether management ensured that the bank had the long-term financial flexibility to continue holding the insurance assets for their full term of expected use.
2. Determine if management, before the bank's purchase of permanent insurance, adequately considered the contractual arrangements and product types that limit product liquidity in order to best optimize the value of the bank's insurance assets and their possible future use as liquidity and funding sources. Contract provisions that should be considered include—
  - a. 1035 exchange fees and "crawl-out restrictions;"
  - b. provisions that would result in the product's categorization for federal tax purposes as a modified endowment contract (MEC) or a non-MEC contract, and
  - c. SVP contract provisions that may limit the bank's ability to surrender a policy early or that would increase the cost of an early surrender.

**REPUTATION-RISK ASSESSMENT**

1. Ascertain whether the bank has taken steps, including obtaining written consent from its insured officers and employees, to reduce its reputation risk that may result from BOLI purchases.
2. Determine if the bank maintains appropriate documentation evidencing that it obtained a formal written consent from its insured officers and employees.
3. Find out what segment of the employee base the bank has insured (i.e., officers or non-officers) and if the bank has taken out very high death benefit policies on employees, including lower-level employees.

**CREDIT-RISK ASSESSMENT**

1. Determine if the bank's management con-

ducted an independent financial analysis of the insurance carrier before the bank's purchase of a life insurance policy.

- a. Ascertain if management continues to monitor the life insurance company's condition on an ongoing basis.
  - b. Verify that the bank's credit-risk management function participated in the review and approval of insurance carriers.
2. Determine whether the bank considered its legal lending limit, its credit concentration guidelines (the aggregate exposures to individual insurance carriers and the life insurance industry, including other bank credit relationships, such as credit exposures involving loans and derivatives), and any state restrictions on BOLI holdings.
  3. Determine whether the bank's credit analysis of its BOLI holdings evaluated whether the policies to be acquired were either separate-account or general-account policies.
    - a. Find out whether the separate-account policies included an SVP contract to protect the bank (as a policyholder) from declines in the fair value of separate-account assets.
    - b. Ascertain if the bank evaluated the insurance carrier's separately contracted SVP provider's repayment capacity.
  4. Find out if the bank has acquired an SVP contract for its separate-account policy in order to reduce income-statement volatility. (SVP contracts protect against declines in value attributable to changes in interest rates; they do not cover default risk.)
  5. If the bank has not purchased an SVP contract, determine if management has established and maintained monitoring and reporting systems that will recognize and respond to price fluctuations in the fair value of separate-account assets.
  6. If the bank has purchased an equity-linked variable life insurance policy, determine whether it is characterized as an effective economic hedge against the bank's equity-linked obligations under its employee benefit plans. (An effective hedge exists when changes in the economic value of the liability or other risk exposure being hedged are matched by counterbalancing changes in the value of the hedging instruments. The economic hedging criteria for equity-linked insurance products lessen the effect of price risk because changes in the amount of the equity-linked liability are required to offset changes in the value of the separate-account assets.)
  7. If the bank is purchasing or has purchased a separate-account insurance product involving equity securities, determine if the bank's management has performed further analysis that—
    - a. compares the equity-linked liability being hedged and the equity securities in the separate account,
    - b. determines a target range for the hedge-effectiveness ratio and establishes a method for measuring ongoing hedge effectiveness, and
    - c. establishes a process for analyzing and reporting to management and the board of directors the effect of the hedge on the bank's earnings and capital ratios (both with and without the hedging transaction).

## MARKET-RISK ASSESSMENT

1. Determine whether management fully understood (before the bank purchased its separate-account products)—
  - a. how the life insurance products expose the bank to interest-rate risk;
  - b. the instruments governing the investment policy, as well as how the separate account is managed;
  - c. the inherent risk of a separate account; and
  - d. whether the bank's risk from the purchase of separate-account products was appropriate.
2. For general-account products, ascertain if management understands the interest-crediting option the bank chose when purchasing the insurance policy.
3. Find out if the bank has established and if it maintains appropriate monitoring and reporting systems for interest-rate fluctuations and their effect on separate-account assets.

## COMPLIANCE/LEGAL-RISK ASSESSMENT

1. Determine whether the bank's compliance

- and audit functions have evaluated its compliance with applicable state insurable-interest and federal tax laws in order to protect the bank's earnings and capital from the loss of tax benefits or from the imposition of fines or penalties by regulatory authorities for violations of, or noncompliance with, laws, rulings, regulations, prescribed practices, and ethical standards.
2. When the bank owns separate-account BOLI, determine whether the bank has implemented and maintains internal control policies and procedures that adequately ensure that it does not take any action that might be interpreted as exercising "control" over separate-account assets.
  3. Determine whether the bank split commissions between a vendor and the bank's own subsidiary or affiliate insurance agency when purchasing life insurance. If so, determine whether the bank's compliance function has assessed the bank's compliance with state and federal securities and insurance laws regarding fee and commission arrangements.
  4. Ascertain whether the bank seeks and documents the advice of legal counsel when determining legal and regulatory issues, requirements, and concerns related to its potential purchase or ownership of BOLI.
  5. For a general-account insurance product, determine if the bank has assigned a standard risk weight of 100 percent to the general-account asset.
  6. For a BOLI separate-account product (when the bank uses the look-through approach to assign risk weights according to the risk-based capital rules)—
    - a. review the bank's documentation, and determine if the bank adequately verified that the separate-account BOLI assets are protected from the insurance company's general creditors in the event of the insurance company's insolvency;
    - b. determine if the standard risk weight of 100 percent was assigned to the bank's BOLI assets when the bank's documentation is inadequate or does not exist;
    - c. verify that a 100 percent risk weight has been assigned to (1) the portion of the bank's insurance asset that represents general-account claims on the insurer (such as DAC and mortality reserves that are realizable on the balance-sheet date) and (2) any portion of the carrying value attributable to an SVP contract (or if the SVP provider is not an insurance company, verify that the correct risk weight has been assigned for that obligor); and
    - d. if the bank used a pro rata approach to risk-weighting the carrying value of a qualifying separate-account policy—
      - verify that the risk weight is applied to the separate account based on the most risky portfolio that could be held by the separate account (as stated in the investment agreement), except for any portions of the carrying value that are general-account claims attributable to either DAC or an SVP (which are generally risk-weighted at 100 percent);
      - verify that in no case may the assigned risk weight for the bank's entire separate-account holding be less than 20 percent; and
      - when the sum of the permitted investments across market sectors in the investment agreement is greater than 100 percent, determine if the bank assigned the highest risk weight for the maximum amount permitted in that asset class, and then applied the next-highest risk weights to the other asset classes until the aggregate of the permitted amounts equals 100 percent.

# Purchase and Risk Management of Life Insurance Internal Control Questionnaire

Effective date May 2006

Section 4042.4

Examiners should use only those internal control questions that are appropriate, given the size, complexity, and growth of a bank's bank-owned life insurance (BOLI) holdings.

## PRELIMINARY RISK ASSESSMENT

1. Have the steps for conducting a preliminary risk assessment been followed, as they are set forth in section 4042.3? Have other relevant factors been considered to determine if further examination review may be warranted, in accordance with risk-focused supervision guidelines?
2. What particular factors have been identified to warrant a review of the bank's purchases and risk management of life insurance?

## OPERATIONAL-RISK ASSESSMENT

### Senior Management and Board of Directors Oversight

1. Has senior management and the board of directors initiated and maintained effective oversight of the bank's BOLI by—
  - a. performing a thorough pre-purchase analysis of its risks and rewards and a post-purchase risk assessment?
  - b. determining the permissibility of the bank's BOLI purchases and holdings under both the applicable state and federal requirements (whichever requirements are more restrictive)?
  - c. determining the types and kinds of risks that are associated with BOLI?
  - d. ascertaining and reviewing the safety-and-soundness considerations associated with the bank's BOLI?
  - e. understanding the complex risk characteristics of the bank's insurance holdings and what role BOLI is to play in the bank's overall business?
2. Does the bank have a comprehensive risk-management process for purchasing and holding BOLI?

### Accounting Considerations

3. When accounting for its holdings of life insurance, did the bank follow the guidance in FASB's Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance"? Are the bank's insurance policies reported on its balance sheet on the basis of each policy's cash surrender value (CSV), less any applicable surrender charges that are not reflected in the reported CSV?
4. On the bank's Call Report, did the bank's management —
  - a. report the carrying value of its BOLI holdings as an "other asset"?
  - b. report the earnings on the bank's holdings as "other noninterest income"?
  - c. report the CSV separately, as required if the CSV amount exceeded the reporting threshold?
  - d. expense only the noninvestment portion of the premium, in the case of bank-owned policies?
  - e. expense the premium for employee-owned insurance purchased by the bank and record a receivable in "other assets" for any portion of the premium to be reimbursed to the bank under a contractual agreement?
5. Were the bank's deferred compensation agreements accounted for using the guidance in the February 11, 2004, Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance?

### Policies and Procedures

6. Does the bank have comprehensive policies and procedures, including guidelines, that limit the aggregate CSV of policies from any one insurance company, as well as the aggregate CSV of policies from all insurance companies?
  - a. Does the board of directors or a designated board committee require senior management to provide adequate and appropriate justification for establishing or revising internal CSV limits on the amount of BOLI the bank holds? Does

this justification take into account the bank's legal lending limits, its capital and credit concentration threshold, and any applicable laws and regulations?

- b. Is written justification required when the amount of the bank's BOLI holdings approaches or exceeds 25 percent of the bank's capital (tier 1 capital plus the allowance for loan and lease losses)? Does the board of directors or a board committee approve this justification?

## Pre-Purchase Analysis

7. Did the bank's management perform a written pre-purchase analysis of its BOLI products?
8. Did management identify the bank's need for BOLI, the appropriate type of insurance to be acquired, and the economic benefits to be derived from the purchase of BOLI? Did this analysis accomplish the following:
- identify the specific risk of loss to be covered by the insurance, or the costs the insurance is supposed to cover?
  - determine what type BOLI (for example, general- or separate-account) and what BOLI features are needed, before acquiring the product?
  - evaluate the permissibility and market risk of any underlying separate-account asset holdings, if separate-account BOLI is held?
  - analyze projected policy values (CSV and death benefits) using various interest-crediting rates and mortality cost assumptions?
  - estimate the size of the employee benefit obligation or the risk of loss to be covered? Did management ensure that the amount of BOLI coverage was appropriate for the bank's objectives and that BOLI was not excessive in relation to this estimate and the associated product risks?
  - review the range of assumptions? Was management able to justify the assumptions with objective evidence, and deem them reasonable in view of previous and expected market conditions?
  - assess whether the present value of the BOLI's expected future cash flows (net of the costs of the insurance) is less than

the estimated present value of the expected after-tax employee benefit costs, when the bank uses BOLI to recover the costs of providing employee benefits?

9. Did the bank's management —
- review and assess its own knowledge of insurance risks, the vendor's qualifications, and the amount of the bank's resources that will be needed to administer and service the BOLI?
  - demonstrate its familiarity with the technical details of the bank's insurance assets, and is management able to explain the reasons for and the risks associated with the product design features that have been selected?
  - make appropriate inquiries to determine whether the vendor has the financial ability to honor its long-term commitments over an extended period of time?
  - assure itself of the vendor's commitment to investing in the operational infrastructure that is necessary to support the BOLI?
  - undertake its own independent review and not rely solely on prepackaged, vendor-supplied compliance information (such reliance is a potential cause for supervisory action)?
  - properly evaluate the characteristics of the available insurance products against the bank's objectives, needs, and risk tolerance?
  - determine if the bank's need for insurance on key persons or on a borrower's loan resulted in a matching of the maturity of the term or declining term insurance to the key person's expected tenure or the maturity of the borrower's loan?
  - conduct a review of the insurance carrier that included—
    - a credit analysis of the potential insurance carrier (the analysis should have been performed in a manner consistent with safe and sound banking practices for commercial lending)?
    - a review of the bank's needs and a comparison of those needs with the proposed carrier's product design, pricing, and administrative services?
    - a review of the insurance carrier's commitment to the BOLI product, as well as the carrier's general reputation, experience in the marketplace, and past performance?

- i. determine whether the total amount of compensation and insurance to be provided to an employee is excessive, if the purchased BOLI will result in the payment of additional compensation?
- j. analyze the associated significant credit risks and the bank's ability to monitor and respond to those risks?
- k. as appropriate, analyze the risks and benefits of BOLI, compared with other available methods for recovering costs associated with the loss of key persons, providing pre- and post-retirement employee benefits, or providing additional employee compensation?
- l. sufficiently document its comprehensive pre-purchase analysis (including its analysis of both the types and product designs of purchased BOLI and the bank's overall level of BOLI holdings)?

### Post-Purchase Analysis

10. Do management and the board of directors annually review the performance of the bank's insurance assets? Does the annual review include—
  - a. a comprehensive assessment of the specific risks associated with permanent insurance acquisitions?
  - b. an identification of employees who are or will be insured (e.g., vice presidents and above, employees of a certain grade level)?
  - c. an assessment of death benefit amounts relative to employee salaries?
  - d. a calculation of the percentage of insured persons still employed by the institution?
  - e. an evaluation of the material changes to BOLI risk-management policies?
  - f. an assessment of the effects of policy exchanges?
  - g. an analysis of mortality performance and the impact on income?
  - h. an evaluation of material findings from internal and external audits and independent risk-management reviews?
  - i. an identification of the reason for and the tax implications of any policy surrenders?
  - j. a peer analysis of BOLI holdings?

### Tax and Insurable-Interest Implications

11. Has the bank's management explicitly considered the financial impact (for example, the tax provisions and penalties) of surrendering a BOLI policy?
12. Does the bank's management have or has it obtained appropriate legal review to ensure that it will be in compliance with applicable tax and state insurable-interest requirements? Is management aware of the relevant tax features of the insurance assets, including whether the bank's purchase would—
  - a. make the bank subject to the alternative minimum tax?
  - b. jeopardize the tax-advantaged status of the bank's insurance holdings?
  - c. qualify (under applicable state law) an insurable ownership interest in the BOLI policy covering the bank's officers or its employees (including any applicable state law pertaining to the insured's consent and the amounts of allowable insurance coverage for an employee)?
13. Did the bank establish an out-of-state trust to hold its BOLI assets, and, if so, has the bank adequately assessed its insurable interest, given the arrangement?

### LIQUIDITY-RISK ASSESSMENT

1. Has the bank's management fully recognized and considered the illiquid nature of the BOLI to be acquired? (An institution's BOLI holdings should be considered when assessing liquidity and assigning the component rating for liquidity.)
2. Did management determine if the bank has the long-term financial flexibility to hold the insurance asset for the full term of its expected use?

### REPUTATION-RISK ASSESSMENT

1. Has the bank's management implemented procedures to ensure that the bank maintains appropriate documentation that evidences employees' informed consent for the bank's purchase of insurance on their lives? Do these procedures ensure that the bank



obtains employees' explicit consent before purchasing the insurance?

2. Has the bank obtained insurance products that insure large segments of its employee base (including the bank's non-officers)? Do these policies provide very high death benefits on employees, possibly causing the bank to be exposed to increased reputation risk if explicit consent was not obtained from the employees?

## CREDIT-RISK ASSESSMENT

1. Did the bank's management conduct an independent financial analysis of the insurance carrier before purchasing the life insurance policy?
  - a. Does management continue to monitor the life insurance company's financial condition on an ongoing basis?
  - b. Did the bank's credit-risk management function participate in the review and approval of insurance carriers?
2. When establishing exposure limits for aggregate BOLI holdings and exposures to individual carriers, did the bank's management consider—
  - a. the bank's legal lending limit?
  - b. the applicable state and federal credit concentration exposure guidelines?
  - c. the aggregate CSV exposures as a percentage of the bank's capital?
3. Has the bank's credit-risk management process taken into account credit exposures arising from both BOLI holdings and other credit exposures (loans, derivatives, and other insurance products) when measuring exposures to individual carriers?
4. Did the bank's credit analysis of its BOLI holdings consider whether the policies to be acquired were separate-account or general-account policies?
  - a. For the separate-account policies, did the credit review include a risk analysis of the underlying separate-account assets?
  - b. For separate-account policies that include a stable value protection (SVP) contract, has the repayment capacity of the insurance carrier's separately contracted SVP providers been evaluated?

## MARKET-RISK ASSESSMENT

1. Did management adequately assess the interest-rate risk exposure of BOLI before purchasing the products for separate-account and general-account assets?
2. Has the bank's management reviewed, and does it understand the instruments governing the separate-account investment policy and its management?
  - a. Does the bank's management understand the risk inherent within the separate account?
  - b. Has the bank's management determined if the risk is appropriate?
3. Have monitoring and reporting systems been established that will enable the bank's management to monitor, measure, and appropriately manage interest-rate risk exposure from BOLI holdings when assessing the bank's overall sensitivity to interest-rate risk?

## COMPLIANCE/LEGAL-RISK ASSESSMENT

1. Has the bank's audit and/or compliance function reviewed the bank's legal and regulatory requirements as they pertain to life insurance holdings? Did the review consider—
  - a. state insurable-interest laws?
  - b. the Employee Retirement Income Security Act of 1974 (ERISA)?
  - c. the Federal Reserve Board's Regulation W (12 CFR 223)?
  - d. applicable federal prohibitions on insider loans, including the Federal Reserve Board's Regulation O, that may apply to split-dollar life insurance arrangements?
  - e. the interagency guidelines for establishing standards for safety and soundness?<sup>1</sup>
  - f. other state and federal regulations applicable to BOLI?
2. To ensure that the life insurance qualifies for its tax-advantaged status, has the bank's management implemented and maintained internal policies and procedures to ensure that "control" will not be exercised over any of the separate-account assets, espe-

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1. For state member banks, see 12 CFR 208, appendix D-1.

- cially those involving privately placed policies?
3. Does the bank's board of directors, its designated board committee, and its management seek the assistance of legal counsel when determining the legal and regulatory issues related to the acquisition and holding of life insurance policies?
  4. Has management thoroughly reviewed, and does it understand, the instruments governing the investment policy and the management of a separate account, before purchasing a separate-account policy?
  5. If the bank has not purchased SVP for a separate-account BOLI policy, has management established the appropriate monitoring and reporting systems that will enable it to recognize and respond to price fluctuations in the fair value of the separate-account assets?
  6. When the bank considers or purchases a separate-account BOLI product involving equity securities, does it analyze the equity securities? Does this analysis—
    - a. compare the specific equity-linked liability being hedged against the securities held in a separate account?
    - b. establish a target ratio for hedge effectiveness, as well as a method for measuring hedge effectiveness on an ongoing basis?
    - c. establish a process for analyzing and reporting to the board of directors, its designated committee, and senior management the effect of the hedge on the bank's earnings and capital ratios (this analysis should include a consideration of the results both with and without the hedging transaction)?
  7. When reporting its risk-based capital, has the bank ensured that it accurately calculates and reports its risk-weighted assets for BOLI holdings according to the risk-based capital guidelines and the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance (see section 4042.1 and SR-04-19 and its attachment)?
    - a. For a general-account insurance product, has the bank applied a standard risk weight of 100 percent to the general-account asset?
    - b. When the bank has applied a look-through approach for separate-account holdings—
      - has management determined if BOLI assets would be protected from the insurance company's general creditors in the event of its insolvency? Has the bank documented its assessment that BOLI assets are protected?
      - has the portion of the carrying value of the separate-account policy (that reflects the amounts attributable to the insurer's DAC and mortality reserves, and any other portion that is attributable to the carrying value of an SVP contract) been risk-weighted using the 100 percent risk weight applicable to the insurer's general-account obligations? Or, if the SVP provider is not an insurance company, has the portion of the carrying value been risk-weighted as appropriate for that obligor?
  8. When the bank has used a pro rata approach to risk-weighting the carrying value of a qualifying separate-account policy, did it use the appropriate procedures, as outlined in the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance (see section 4042.1 and SR-04-19 and its attachment)?
    - a. Has the bank ensured that its assigned aggregate risk weight for all separate-account BOLI holdings will be 20 percent or more?
    - b. When the sum of the permitted investments across market sectors in the investment agreement is greater than 100 percent, was the highest risk weight applied for the maximum amount permitted in that asset class, and was the next-highest risk weight then applied until the cumulative permitted amounts equal 100 percent?

# Insurance Sales Activities and Consumer Protection in Sales of Insurance

Effective date April 2008

Section 4043.1

Banking organizations have long been engaged in the sale of insurance products and annuities, although these activities historically have been subject to several restrictions. For example, until recently, national banks could sell most types of insurance, but only through an agency located in a small town. Bank holding companies also were permitted to engage in only limited insurance agency activities under the Bank Holding Company Act. State-chartered banks, on the other hand, generally have been permitted to engage in insurance sales activities as agents to the extent permitted by state law.

The Gramm-Leach-Bliley Act of 1999 (the GLB Act), however, authorized national banks and state-chartered member banks to sell all types of insurance products through a financial subsidiary. *The GLB Act generally did not change the powers of banks to sell insurance directly.* As a result of the GLB Act and marketplace developments, many banking organizations are increasing the range and volume of their insurance and annuities sales activities. To the extent permitted by applicable law, banking organizations may conduct insurance and annuity sales activities through a variety of structures and delivery channels, including ownership of an insurance underwriter or an insurance agency or broker, the employment by a bank of licensed agents, a joint marketing arrangement with a producer,<sup>1</sup> independent agents located at a bank's office, direct mail, telemarketing, and Internet marketing.

A banking organization may also conduct insurance or annuity sales activities through a managing general agent (MGA). An MGA is a wholesaler of insurance products and services to insurance agents. The MGA has a contractual agreement with an insurance carrier to assume

functions for the carrier, which may include marketing, accounting, data processing, policy recordkeeping, and monitoring or processing claims. The MGA may rely on various local agents or agencies to sell the carrier's products. Most states require an MGA to be licensed.

## OVERVIEW AND SCOPE

The following guidance pertains to state member banks that are either directly or indirectly engaged in the sale of insurance or annuity products. Examiner guidance on performing appropriate risk assessments of a state member bank's insurance and annuity sales activities is included.<sup>2</sup> Additionally, guidance is provided for examining a state member bank's compliance with the consumer protection rules relating to insurance and annuities sales activities that are contained in the Board's December 2000 revisions to Regulation H (subpart H) (12 CFR 208.81–86), "Consumer Protection in Sales of Insurance" (CPSI). Subpart H, which became effective on October 1, 2001, implements the consumer protection requirements of the GLB Act, which are codified at 12 USC 1831x. (See 65 *Fed. Reg.* 75841, December 4, 2000.) The regulation applies not only to the sale of insurance products or annuities by the bank, but also to activities of any person engaged in insurance product or annuity sales on behalf of the bank, as discussed in this guidance. The guidance is generally not applicable to debt-cancellation contracts and debt-suspension agreements, unless these products are considered to be insurance products by the state in which the sales activities are conducted.

The GLB Act permits state member banks that are not authorized by applicable state law to sell insurance directly to do so through a financial subsidiary.<sup>3</sup> A financial subsidiary engaged in insurance sales may be located wherever state

1. The term "producer" refers broadly to persons, partnerships, associations, limited liability corporations, etc., that hold a license to sell or solicit contracts of insurance to the public. Insurance agents and agencies are producers who, through a written contractual arrangement known as a direct appointment, represent one or more insurance underwriters. Independent agents and agencies are those producers that sell products underwritten by one or more insurance underwriters. Captive agents and agencies represent a specific underwriter and sell only its products. Brokers are producers that represent the purchaser of insurance and obtain bids from competing underwriters on behalf of their clients. State insurance laws and regulations often distinguish between an insurance agent and a broker; in practice, the terms are often used interchangeably.

2. The term "risk assessment" denotes the work product described in SR-97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions," and entails an analysis of (1) the level of inherent risk by type of risk (operational, legal, market, liquidity, credit, and reputation risk) for a business line or business function, (2) the adequacy of management controls over that business line or business function, and (3) the direction of the risk (increasing, decreasing, or stable).

3. Rules pertaining to state member bank financial subsid-

law permits the establishment and operation of an insurance agency. Such subsidiaries, however, would be subject to state licensing and other requirements.

The Federal Reserve is responsible for evaluating the consolidated risk profile of a state member bank. This responsibility includes determining the risks posed to the state member bank from the insurance and annuity sales activities it conducts directly or indirectly, as well as determining the effectiveness of the bank's risk-management systems. However, the GLB Act also established a regulatory framework that is designed to ensure that the Federal Reserve coordinates with, and relies to the extent possible on information from, the state insurance authorities when it is supervising the insurance activities a state member bank conducts through a functionally regulated subsidiary.

Consistent with the Federal Reserve's risk-focused framework for supervising banking organizations, resources allocated to the review of insurance sales activities should be commensurate with the significance of the activities and the risk they pose to the bank. The scope of the review depends on the significance of the activity to the state member bank and the extent to which the bank is directly involved in the activity. Examiner judgment is required to tailor the reviews, as appropriate, on the basis of the legal, organizational, and risk-management structure of the state member bank's insurance and annuity sales activities and on other relevant factors.<sup>4</sup>

## SUPERVISORY APPROACH FOR THE REVIEW OF INSURANCE AND ANNUITY SALES ACTIVITIES

### Supervisory Objective

The primary objective for the review of a state member bank's insurance and annuity sales activities is to determine the level and direction

aries are found in the Board's Regulation H (12 CFR 208.71-77).

4. See SR-02-01, "Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of \$5 Billion or Less," and section 1000.1 for a discussion of the Federal Reserve's risk-focused examinations and the risk-focused supervision program for community banking organizations. See also SR-97-24 and SR-97-25.

of risk such activities pose to the state member bank. The review includes insurance and annuity sales activities the state member bank conducts directly (by or in conjunction with a subsidiary or affiliate) or through a third-party arrangement. Primary risks that may arise from insurance sales activities include operational, legal, and reputational risk. If the state member bank does not adequately manage these risks, they could have an adverse impact on its earnings and capital. The examiner should produce (1) a risk assessment that summarizes the level of inherent risk to the state member bank by risk category and (2) an assessment of the adequacy of board of directors' and management oversight of the insurance and annuity sales activities, including their internal control framework. For those state member banks selling insurance or annuity products, or that enter into arrangements under which another party sells insurance or annuity products at the bank's offices or on behalf of the bank, a second objective of the review is to determine the bank's compliance with the consumer protection provisions of the GLB Act and the CPSI regulation.

### State Regulation of Insurance Activities

Historically, insurance activities have primarily been regulated by the states. In 1945, Congress passed the McCarran-Ferguson Act, which granted states the power to regulate most aspects of the insurance business. The McCarran-Ferguson Act states that "no act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance" (15 USC 1012(b)).

State regulation of insurance producers is centered on the protection of the consumer and consists primarily of licensing and continuing education requirements for producers. A producer generally must obtain a license from each state in which it sells insurance and for each product sold. Each state in which a producer sells insurance has regulatory authority over the producer's activities in the state.

The GLB Act does include several provisions that are designed to keep states from (1) unfairly regulating a bank to prevent it from engaging in

authorized insurance activities or (2) otherwise discriminating against banks engaged in insurance activities. These provisions are complex and beyond the scope of this guidance. However, the GLB Act generally does not prohibit a state from requiring a bank or bank employee engaged in insurance sales, solicitation, or cross-marketing activities to be licensed within the state.

State insurance regulatory authorities do not conduct routine, periodic examinations of an insurance producer. A state examination of an insurance producer is generally conducted only on an ad hoc basis and is primarily based on the volume and severity of consumer complaints. The state examination may also be based in part on the producer's market share and on previous examination findings. Additionally, a review of a producer would typically not assess its financial condition.

A state's market conduct examination of *insurance sales practices* is focused at the insurance-underwriter level.<sup>5</sup> The insurance underwriter is generally held accountable for compliance with state insurance laws to protect the consumer from the unfair sales practices of any producer that markets the insurance underwriter's products. Market conduct examinations of an insurance underwriter may potentially uncover a concern about a particular producer, such as a bank-affiliated producer.<sup>6</sup> However, in the past, a state insurance regulatory authority has not typically examined a producer unless the producer is owned by the insurance underwriter.

Generally, market conduct examinations include reviews of the insurance underwriters' complaint handling, producer licensing, policyholder service, and marketing and sales practices. Typically, a state authority will direct a corrective action for insurance sales activity at the underwriter. The states generally have specific guidance for their market conduct examinations of life, health, and property/casualty<sup>7</sup>

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5. Generally, market conduct reviews of *insurance underwriters* are conducted on an ad hoc basis, triggered primarily by the volume and severity of consumer complaints, and are based on the underwriter's market share or on previous examination findings. In some states, however, market conduct reviews of insurance underwriters are conducted on a periodic, three- to five-year schedule.

6. The terms "insurance underwriter," "insurer," "insurance carrier," and "insurance company" are industry terms that apply similarly to the party to an insurance arrangement who undertakes to indemnify for losses, that is, the party that assumes the principal risk under the contract.

7. Property insurance indemnifies a person who has an

lines of business—guidance that corresponds to regulations related to advertising, misrepresentations, and disclosures for these different business lines. The reports of examination issued by the state insurance departments are usually available to the public.

Because the underwriter, not the producer, is liable to the insured, the failure of an insurance producer generally would not result in financial loss to consumers or state guarantee funds. Consequently, there are no regulatory capital requirements for insurance producers, nor do states require regulatory reporting of financial statement data on insurance producers. While the underwriter is ultimately liable to the insured, in some instances, a producer and its owner may be held liable for misrepresentations, as well as for violations of laws and regulations.

## Functional Regulation

Under the GLB Act, banking supervisors' reviews of insurance or securities activities conducted in a bank's functionally regulated subsidiary are not to be extensions of more traditional bank-like supervision. Rather, to the extent possible, bank supervisors are to rely on the functional regulators to appropriately supervise the insurance and securities activities of a functionally regulated subsidiary. A functionally regulated subsidiary includes any subsidiary of a bank that (1) is engaged in insurance activities and subject to supervision by a state insurance regulator or (2) is registered as a broker-dealer with the Securities and Exchange Commission. The GLB Act does *not* limit the Federal Reserve's supervisory authority with respect to a *bank* or the insurance activities conducted by a bank. The functional regulators for insurance sales activities, including the activities of insurance producers, consist of the insurance departments in each of the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, American Samoa, and Guam.

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interest in a physical property for loss of the property or the loss of its income-producing abilities. Casualty insurance is primarily concerned with the legal liability for losses caused by injury to persons or damage to the property of others. It may also include such diverse forms of insurance as crime insurance, boiler and machinery insurance, and aviation insurance. Many casualty insurers also underwrite surety bonds.

The GLB Act places certain limits on the ability of the Federal Reserve to examine, obtain reports from, or take enforcement action against a functionally regulated nondepository subsidiary of a state member bank. For purposes of these limitations, a subsidiary licensed by a state insurance department to conduct insurance sales activities is considered functionally regulated only with respect to its insurance activities and any activities incidental to these activities.<sup>8</sup>

The GLB Act indicates that the Federal Reserve must rely, to the fullest extent possible, on information obtained by the appropriate state insurance authority of a nondepository insurance agency subsidiary of a state member bank. In addition, the Federal Reserve may examine a functionally regulated subsidiary of a state member bank only in the following situations:

- The Federal Reserve has reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to an affiliated depository institution, as determined by the responsible Reserve Bank and Board staff.
- After reviewing relevant information (including information obtained from the appropriate functional regulator), it is determined that an examination is necessary to adequately understand and assess the banking organization's systems for monitoring and controlling the financial and operational risks that may pose a threat to the safety and soundness of an affiliated depository institution.
- On the basis of reports and other available information (including information obtained from the appropriate functional regulator), there is reasonable cause to believe that the subsidiary is not in compliance with a federal law that the Federal Reserve has specific jurisdiction to enforce with respect to the subsidiary (including limits relating to transactions with affiliated depository institutions), and the Federal Reserve cannot assess such compliance by examining the state member bank or other affiliated depository institution.

Other similar restrictions limit the ability of the Federal Reserve to obtain a report directly from, or take enforcement action against, a

functionally regulated nonbank subsidiary of a state member bank. These GLB Act limitations do *not* apply to a state member bank even if the state member bank is itself licensed by a state insurance regulatory authority to conduct insurance sales activities.

Staff who are conducting reviews of state member bank insurance or annuity sales activities should be thoroughly familiar with SR-00-13, which provides guidance on reviews of functionally regulated state member bank subsidiaries. Reserve Bank staff may conduct an examination of a functionally regulated subsidiary, or request a specialized report from a functionally regulated subsidiary, only after obtaining approvals from the appropriate staff of the Board's Division of Banking Supervision and Regulation.

When preparing or updating the risk assessment of a state member bank's insurance or annuity sales activities, Federal Reserve staff, when appropriate, should coordinate their activities with the appropriate state insurance authorities. The Federal Reserve's supervision of state member banks engaged in insurance sales activities is not intended to replace or duplicate the regulation of insurance activities by the appropriate state insurance authorities.

### *Information Sharing with the Functional Regulator*

The Federal Reserve and the National Association of Insurance Commissioners (NAIC) approved a model memorandum of understanding (MOU) on the sharing of confidential information between the Federal Reserve and individual state insurance departments.<sup>9</sup> The Board also approved the delegation of authority to the Board's general counsel to execute agreements with individual states, based on this MOU. Examiners should follow required Board administrative procedures before sharing any confidential information with a state insurance regulator. (These procedures generally require Federal Reserve staff to identify and forward to Board staff for review any confidential information that may be appropriate to share with the applicable

8. For example, if a state member bank subsidiary engages in mortgage lending and is also licensed as an insurance agency, it would be considered a functionally regulated subsidiary only to the extent of its insurance sales activities.

9. The NAIC is the organization of insurance regulators from the 50 states, the District of Columbia, and the four U. S. territories. The NAIC provides a forum for the development of uniform policy among the states and territories. The NAIC is not a governmental or regulatory body.

state insurance regulator concerning insurance sales activities conducted by state member banks.) The Board's Division of Consumer and Community Affairs CP Letter 2001-11 outlines the procedures for sharing consumer complaint information with state insurance regulators.

## STATUTORY AND REGULATORY REQUIREMENTS AND POLICY GUIDANCE

### Privacy Rule and the Fair Credit Reporting Act

State member banks that sell insurance to consumers must comply with the privacy provisions under title V of the GLB Act (12 USC 6801–6809), as implemented by the Board's Regulation P (12 CFR 216) (the privacy rule). Functionally regulated state member bank nonbank insurance agency subsidiaries are not covered by the Federal Reserve's privacy rule; however, they must comply with the privacy regulations (if any) issued by their relevant state insurance regulator.

The privacy rule regulates a state member bank's treatment of nonpublic personal information about a "consumer," an individual who obtains a financial product or service (such as insurance) from the institution for personal, family, or household purposes. The privacy rule generally requires a bank to provide a notice to each of its customers that describes its privacy policies and practices no later than when the bank establishes a business relationship with the customer. The privacy rule also generally prohibits a bank from disclosing any nonpublic personal information about a consumer to any nonaffiliated third party, unless the bank first provides to the consumer a privacy notice and a reasonable opportunity to prevent (or "opt out" of) the disclosure, and the consumer does not opt out. The privacy rule permits a financial institution to provide a joint notice with one or more of its affiliates or other financial institutions, as identified in the privacy notice itself, provided that the notice is accurate with respect to the institution and the other institutions.

While the privacy rule applies to the sharing of nonpublic personal information by a bank with nonaffiliated third parties, the sharing of certain consumer information with affiliates or

nonaffiliates may be subject to the Fair Credit Reporting Act (FCRA) as well. For example, under the FCRA, if a bank wants to share with its insurance subsidiary information from a credit report or from a consumer application for credit (such as the consumer's assets, income, or marital status), the bank must first notify the consumer about the intended sharing and give the consumer an opportunity to opt out. The same rules would apply to an insurance company that wants to share information from credit reports or from applications for insurance with an affiliate or a third party.

### Anti-Tying Prohibitions

Federal law (section 106(b) of the BHC Act Amendments of 1970 (12 USC 1972(b))) generally prohibits a bank from requiring that a customer purchase a product or service from the bank or an affiliate as a prerequisite to obtaining another product or service (or a discount on the other product or service) from the bank. This prohibition applies whether the customer is retail or institutional, or whether the transaction is on bank premises or off premises. For example, a state member bank may not require that a customer purchase insurance from the bank or a subsidiary or affiliate of the bank in order to obtain a loan from the bank (or a reduced interest rate on the loan).<sup>10</sup>

### Policy Statement on Income from Sale of Credit Life Insurance

The Federal Reserve Board's Policy Statement on Income from Sale of Credit Life Insurance (see the *Federal Reserve Regulatory Service* at 3-1556) sets forth the principles and standards that apply to a bank's sales of credit life insurance and the limitations that apply to the receipt of income from those sales by certain individuals and entities associated with the bank. See also the examination procedures related to this policy statement in section 2130.3.

10. See section 2040.1 and "Tie-In Considerations of the BHC Act," section 3500.0, of the *Bank Holding Company Supervision Manual*.

## RISK-MANAGEMENT PROGRAM

### Elements of a Sound Insurance or Annuity Sales Program

A state member bank engaged in insurance or annuity sales activities should—

- conduct insurance sales programs in a safe and sound manner;
- have appropriate written policies and procedures in place that are commensurate with the volume and complexity of its insurance sales activities;
- obtain its board of directors' approval of the scope of the insurance and annuity sales program and of written policies and procedures for the program;
- effectively oversee the sales program activities, including third-party arrangements;
- have an effective, independent internal audit and compliance program;
- appropriately train and supervise the employees conducting insurance and annuity sales activities;
- take reasonable precautions to ensure that disclosures to customers for insurance and annuity sales and solicitations are complete and accurate and are in compliance with applicable laws and regulations;
- ensure compliance with all applicable federal, state, or other jurisdiction regulations, including compliance with sections 23A and 23B of the Federal Reserve Act as that act applies to affiliate transactions; and
- have controls in place to ensure accurate and timely financial reporting.

Every state member bank conducting insurance or annuity sales activities should have appropriate, board-approved policies, procedures, and controls in place to monitor and ensure that it complies with both federal and state regulatory requirements. Consistent with the principle of functional regulation, the Federal Reserve will rely primarily on the appropriate state insurance authorities to monitor and enforce compliance with applicable state insurance laws and regulations, including state consumer protection laws and regulations governing insurance sales.

### *Sales Practices and Handling of Customer Complaints*

Every state member bank engaged in insurance or annuity sales activities should have board-approved policies and procedures for handling customer complaints related to these sales. The customer complaint process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. A state member bank's board of directors and senior management should also review complaints if the complaints involve significant compliance issues that may pose a risk to the state member bank.

### *Third-Party Arrangements*

State member banks, to the extent permitted by applicable law, may enter into agreements with third parties, including unaffiliated agents or agencies, to sell insurance or annuities or provide expertise and services that otherwise would have to be developed in-house. Many banks hire third parties to assist in establishing an insurance program or to train their own insurance staff. A bank may also find it advantageous to offer more specialized insurance products through a third-party arrangement.

A state member bank's management should conduct a comprehensive review of an unaffiliated third party before entering into any arrangement to conduct insurance or annuity sales with the third party. The review should include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the state member bank, which includes compliance with applicable consumer protection laws and regulations.

The state member bank's board of directors or its designated committee should approve any agreements with third parties. Agreements should outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the state member bank's office space, equipment, and personnel. If an arrangement includes dual employees (for example, bank employees who are also employed by an independent third party), the agreement must provide for written employment contracts that specify the duties of



these employees and their compensation arrangements.

In addition, a third-party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable. The agreement should authorize the banking organization to monitor the third party's compliance with its agreement, as well as authorize the bank to have access to third-party records considered necessary to evaluate compliance. A state member bank that contracts with a functionally regulated third party should obtain from and review, as appropriate, any relevant, publicly available regulatory reports of examination of the third party.<sup>11</sup> Finally, the agreement should provide for indemnification of the institution by the unaffiliated third party for any losses caused by the conduct of the third party's employees in connection with its sales activities.

The state member bank is responsible for ensuring that any third party or dual employee selling insurance at or on behalf of the bank is appropriately trained either by the bank or the third party with respect to compliance with the minimum disclosures and other requirements of the CPSI regulation and applicable state regulations. The banking organization should obtain and review copies of third-party training and compliance materials to monitor the third party's performance of its disclosure and training obligations.

### *Designation, Training, and Supervision of Personnel*

A state member bank hiring personnel to sell insurance or annuities should investigate the backgrounds of the prospective employees. When a candidate for employment has previous insurance industry experience, the state member bank should have procedures to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators.<sup>12</sup>

11. The reports of examination issued by state insurance regulators are generally public documents. Many states do not conduct periodic examinations of insurance sales activities.

12. Information from the states on the issuance and termination of producer licenses and on producers' compliance with continuing education requirements is available from the NAIC database known as the National Insurance Producer Registry (NIPR).

The state member bank should require its own insurance or annuity sales personnel or third-party sales personnel selling at or on behalf of the bank to receive appropriate training and licensing. Training should cover appropriate policies and procedures for the bank's sales of insurance and annuity products. Personnel who are referring potential or established customers to a licensed insurance producer should also be trained to ensure that referrals are made in conformance with the CPSI regulation, if applicable. The training should also include procedures and guidance to ensure that an unlicensed or referring individual cannot be deemed to be acting as an insurance agent that is subject to licensing requirements.

When insurance or annuities are sold by a state member bank or third parties at an office of, or on behalf of, the organization, the institution should have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as for supervising the referral activities of bank employees not authorized to sell these products. A state member bank also should designate supervisory personnel responsible for monitoring compliance with any third-party agreement, as well as with the CPSI regulation, if applicable.

### *Compliance*

State member banks should have policies and procedures to ensure that insurance or annuity sales activities are conducted in compliance with applicable laws and regulations (including the CPSI regulation for sales conducted by or on behalf of the state member bank) and the institution's internal policies and procedures. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. For example, sales-compensation programs should be conducted in a manner that would not expose the bank to undue legal or reputation risks. The compliance procedures should also provide for a system to monitor customer complaints and their resolution. Where applicable, compliance procedures also should call for verification that third-party sales are being conducted in a manner consistent with the governing agreement with the banking organization.

The compliance function should be conducted independently of the insurance and annuity prod-

uct sales and management activities. Compliance personnel should determine the scope and frequency of their reviews, and findings of compliance reviews should be reported directly to the state member bank's board of directors or to its designated board committee.

## RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

A risk assessment of insurance activities may be accomplished in the course of conducting a regularly scheduled state member bank examination or as a targeted review. The purpose of preparing the risk assessment is to determine the level and direction of risk to the bank arising from its insurance and annuity sales activities. Risks to state member banks engaged in insurance and annuity sales programs consist primarily of legal, reputational, and operational risk, all of which may lead to financial loss. After completing the risk assessment, if material concerns remain, the Board's Division of Banking Supervision and Regulation staff should be consulted for further guidance.

Legal and reputational risk may arise from a variety of sources, such as fraud; noncompliance with statutory or regulatory requirements, including those pertaining to the handling of premiums collected on behalf of the underwriter; claims processing; insurance and annuity sales practices; and the handling of "errors and omissions" claims.<sup>13</sup> Other sources of legal and reputational risk may arise from failing to safeguard nonpublic customer information, a high volume of customer complaints, or public regulatory sanctions against a producer.

Legal and reputational risks may also arise from an agent's obligation to provide a customer with products that are suited to the customer's particular needs and are priced and sold in accordance with state regulations. Additionally, an agent or agency may be liable for failing to carry out the appropriate paperwork to bind a policy that it has sold to a customer, or for making an error in binding the policy. State insurance departments generally are permitted

by law to suspend or revoke a producer's license and assess monetary penalties against a producer if warranted.

Operational risk may arise from errors in processing sales-related information or from a lack of appropriate controls over systems or staff responsible for carrying out the insurance or annuity sales activities. Additionally, state member banks that have recently commenced insurance or annuity sales activities, or that are expanding their insurance or annuity sales business, also are exposed to risk arising from inadequate strategic and financial planning associated with the activities, which could result in financial loss. Examiners should be attuned to risks that may arise from inadequate controls over insurance activities, a rapid expansion of the insurance or annuity sales programs offered by the state member bank, the introduction of new products or delivery channels, and legal and regulatory developments.

Operational risk may arise from inadequate premium-payment procedures and trust-account-balance administration by an agency. When the insurance agency bills the insured, the agent must comply with requirements for forwarding the payments to the insurer and for safekeeping the funds. Inadequate internal controls over this activity may result in the inappropriate use of these funds by the agent or agency. The state member bank should ensure that appropriate controls are in place to verify that all funds that are owed to the insurer or the insured are identified in the trust account and that the account is in balance.

When conducting a risk assessment, the examiner should first obtain relevant information to determine the existence and scale of insurance or annuity sales activity. Such information is available in the state member bank's Uniform Bank Performance Report (UBPR) and in other System reports on insurance activities. Relevant reports, including applicable balance sheets and income statements for the insurance and annuity sales activities, may also be obtained from the state member bank. When preparing a risk assessment for an insurance or annuity sales activity that is conducted by a functionally regulated nonbank subsidiary of a state member bank, examiners should rely, to the fullest extent possible, on information available from the state member bank and the appropriate state insurance regulator for the subsidiary. If information that is needed to assess the risk cannot be obtained from the state member bank or the

13. Errors and omissions insurance indemnifies the insured against loss sustained because of an error or oversight by the insured. For instance, an insurance agency generally purchases this type of coverage to protect itself against such things as failing to issue a policy.

applicable functional regulator, the examiner should consult with the appropriate designated Board staff. Requests should not be made directly to a functionally regulated nonbank insurance and annuity sales subsidiary of a state member bank without first obtaining approval from the appropriate Board staff.

## CONSUMER PROTECTION IN SALES OF INSURANCE RULES

### Overview of the CPSI Regulation

The CPSI regulation is applicable to all insured depository institutions.<sup>14</sup> The regulation, however, generally does not apply to nonbank affiliates or subsidiaries of a state member bank unless the company engages in the retail sale of insurance products or annuities at an office of, or on behalf of, an insured depository institution. Interpretations of the regulation issued by the federal banking agencies are found in appendix A of this section. Federal Reserve examiners are responsible for reviewing state member banks' compliance with the regulation.

The regulation applies to the retail sale of insurance products and annuities by banks or by any other person at an office of a bank, or acting on behalf of a bank. For purposes of the CPSI regulation, "office" means the premises of the bank where retail deposits are accepted. The regulation applies only to the retail sale of insurance or annuity products—that is, when the insurance is sold or marketed to an individual primarily for personal, family, or household purposes.

### *Misrepresentations Prohibited*

The regulation prohibits a bank or other covered person from engaging in any practice or using any advertisement at any office of, or on behalf of, the bank or a subsidiary of the bank if the practice or advertisement could mislead any person or otherwise cause a reasonable person to erroneously believe—

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14. The CPSI regulation applies to all federally insured depository institutions, including all federally chartered U.S. branches and state-chartered insured U.S. branches of foreign banking organizations.

- that the insurance product or annuity is backed by the federal government or the bank or is insured by the Federal Deposit Insurance Corporation (FDIC);
- that an insurance product or annuity does not have investment risk, including the potential that principal may be lost and the product may decline in value, when in fact the product or annuity does have such risks; or
- in the case of a bank or subsidiary of the bank at which insurance products or annuities are sold or offered for sale, that (1) the bank may condition approval of an extension of credit to a consumer by the bank or subsidiary on the purchase of an insurance product or annuity from the bank or a subsidiary of the bank, and (2) the consumer is not free to purchase the insurance product or annuity from another source.

The regulation also incorporates the anti-tying provisions of section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 USC 1972). Additionally, banks are prohibited from selling life or health insurance products if the status of the applicant or insured as a victim of domestic violence or as a provider of services to domestic violence victims is considered as a factor in decision making on the product, except as expressly authorized by state law.

### *Insurance Disclosures*

The CPSI regulation also requires that a bank or a person selling insurance at an office of, or on behalf of, a bank make the following affirmative disclosures (to the extent accurate), both orally and in writing, before the completion of the initial sale of an insurance product or an annuity to a consumer. However, sales by mail or, if the consumer consents, via electronic media (such as the Internet) do not require oral disclosure.

- The insurance product or annuity is not a deposit or other obligation of, or guaranteed by, the bank or an affiliate of the bank.
- The insurance product or annuity is not insured by the FDIC or any other U.S. government agency, the bank, or (if applicable) an affiliate of the bank.
- The insurance product or annuity, if applicable, has investment risk, including the possible loss of value.

For telephone sales, written disclosures must be mailed within three business days. The above disclosures must be included in advertisements and promotional materials for insurance products and annuities, unless the advertisements or promotional materials are of a general nature and describe or list the nature of services or products offered by the bank. Disclosures must be conspicuous and readily understandable.

### *Credit Disclosures*

When an application for credit is made in connection with the solicitation, offer, or sale of an insurance product or annuity, the consumer must be notified that the bank may not condition the extension of credit on either (1) the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates or (2) the consumer's agreement not to obtain, or a prohibition on the consumer from obtaining, an insurance product or annuity from an unaffiliated entity. These disclosures must be made both orally and in writing; however, applications taken by mail or, if the consumer consents, via electronic media, do not require oral disclosure. For telephone applications, the written disclosure must be mailed within three business days. The disclosures must be conspicuous and readily understandable.

### *Consumer Acknowledgment*

The bank must obtain written or electronic acknowledgments of the consumer's receipt of the disclosures described above at the time they are made or at the completion of the initial purchase. For telephone sales, the bank must receive an oral acknowledgment and make a reasonable effort to obtain a subsequent written or electronic acknowledgment.

### *Location*

Insurance and annuity sales activities must take place, to the extent practicable, in an area physically segregated from one where retail deposits are routinely accepted from the general public (such as teller windows). The bank must clearly identify and delineate areas where insurance and annuity sales activities occur.

### *Referrals*

Any person who accepts deposits from the public in an area where deposits are routinely accepted may refer a consumer to a qualified person who sells insurance products or annuities only if the person making the referral receives no more than a one-time, nominal fee of a fixed dollar amount for the referral. The amount of the referral fee may *not* depend on whether a sale results from the referral.

### *Qualifications*

A bank may not permit any person to sell or offer insurance products or annuities at its office or on its behalf, unless that person is at all times properly qualified and licensed under applicable state law for the specific products being sold or recommended.

### **Relationship of the CPSI Regulation to State Regulation**

The GLB Act contains a legal framework for determining the effect of the CPSI regulation on state laws governing the sale of insurance, including state consumer protection standards. In general, if a state has legal requirements that are inconsistent with, or contrary to, the CPSI regulation, initially the federal regulation does not apply in the state. However, the federal banking agencies may, after consulting with the state involved, decide to preempt any inconsistent or contrary state laws if the agencies find that the CPSI regulation provides greater protections than the state laws. It is not expected that there will be significant conflict between state and federal laws in this area. If the consumer protection laws of a particular state appear to be inconsistent with and less stringent (that is, provide less consumer protection) than the CPSI regulation, examiners should inform the staff of the Board's Division of Banking Supervision and Regulation.

### **Relationship to Federal Reserve Guidance on the Sale of Nondeposit Investment Products**

When a bank sells insurance products or annu-

ities that also are securities (such as variable life insurance annuities), it must conform with the applicable Federal Reserve and interagency guidance pertaining to a bank's retail sales of non-deposit investment products (NDIPs).<sup>15</sup> If the CPSI regulation and the guidance pertaining to NDIPs conflict, the CPSI regulation prevails.

## Examining a State Member Bank for Compliance with the CPSI Regulation

Examinations for compliance with the CPSI regulation should be conducted consistent with the risk-focused supervisory approach when a state member bank sells insurance products or annuities directly, or when a third party sells insurance or annuities at or on behalf of, a state member bank. To the extent practicable, the examiner should conduct the review at the state member bank. In certain instances, however, the examiner's review at the state member bank may identify potential supervisory concerns about the state member bank's compliance with the CPSI regulation as it pertains to insurance or annuities sales conducted by a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance products or annuities at or on behalf of the state member bank.

If the examiner determines that an on-site review of a functionally regulated nonbank affiliate or subsidiary of the state member bank is appropriate to adequately assess the state member bank's compliance with the CPSI regulation, the examiner should discuss the situation with staff of the Board's Division of Banking Supervision and Regulation. The approval of the Division of Banking Supervision and Regulation's officer that is responsible for the supervisory policy and examination guidance pertaining to insurance and annuity sales activities should be obtained before examining or requesting any information directly from a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance or annuity products at or on behalf of the state member bank.

The examination guidelines described in section 4043.3 apply to retail sales, solicitations, advertisements, or offers of insurance products and annuities by any state member bank or any

other person that is engaged in such activities at an office of the bank or on behalf of the state member bank. For purposes of the CPSI regulation, activities "on behalf of a state member bank" include activities in which a person, whether at an office of the bank or at another location, sells, solicits, advertises, or offers an insurance product or annuity and in which at least one of the following applies:

- The person represents to a consumer that the sale, solicitation, advertisement, or offer of any insurance product or annuity is by or on behalf of the bank.
- The bank refers a consumer to a seller of insurance products or annuities, and the bank has a contractual arrangement to receive commissions or fees derived from the sale of an insurance product or annuity resulting from the bank's referral.
- Documents evidencing the sale, solicitation, advertising, or offer of an insurance product or annuity identify or refer to the bank.

## APPENDIX A—JOINT INTERPRETATIONS OF THE CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

In response to a banking association's inquiries, the federal banking agencies jointly issued interpretations regarding the Consumer Protection in Sales of Insurance (CPSI) regulation.<sup>1</sup> A joint statement, issued on August 17, 2001, contains responses to a set of questions relating to disclosure and acknowledgment, the scope of applicability of the regulation, and compliance. Additionally, a February 28, 2003, joint statement responded to a request to clarify whether the disclosure requirements apply to renewals of pre-existing insurance policies sold before October 1, 2001, the effective date of the regulation. The issues raised and the banking agencies' responses are summarized below.

1. These letters, issued jointly by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, may be accessed on these agencies' web sites.

15. Interagency Statement on Retail Sales of Nondeposit Investment Products, February 17, 1994. See SR-94-11.

## Disclosures

### *Credit Disclosures*

A bank or other person who engages in insurance sales activities at an office of, or on behalf of, a bank (“a covered person”) must make the credit disclosures set forth in the regulation if a consumer is solicited to purchase insurance while the consumer’s loan application is pending. A consumer’s application for credit is still “pending” for purposes of the regulation if the depository institution has approved the consumer’s loan application but not yet notified the consumer. Until the consumer is notified of the loan approval, the covered person must provide the credit disclosures if the consumer is solicited, offered, or sold insurance.

### *Disclosures for Sales by Mail and Telephone*

The regulation requires a covered person to provide oral disclosures and to obtain an oral acknowledgment of these disclosures when sales activities are conducted by telephone. This requirement applies regardless of whether the consumer will also receive and acknowledge written disclosures in person, through the mail, or electronically.

### *Use of Short-Form Insurance Disclosures*

There is no short form for the credit disclosures. A depository institution, however, may use the short-form insurance disclosures set forth below in visual media (such as television broadcasting, ATM screens, billboards, signs, posters, and written advertisements and promotional materials):

- NOT A DEPOSIT
- NOT FDIC-INSURED
- NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY
- NOT GUARANTEED BY THE BANK
- MAY GO DOWN IN VALUE

### *Acknowledgment of Disclosures*

*Reasonable efforts to obtain written acknowledgment.* The banking agencies have not pre-

scribed any steps that must be taken for a depository institution’s efforts to obtain a written acknowledgment to be deemed “reasonable” in a transaction conducted by telephone. Examples of reasonable efforts, however, include—

- providing the consumer with a return-addressed envelope or similar means to facilitate the consumer’s return of the written acknowledgment,
- making a follow-up phone call or contact,
- sending a second mailing, or
- similar actions.

The covered person should (1) maintain documentation that the written disclosures and the request for written acknowledgment of those disclosures were mailed to the consumer and (2) should record his or her efforts to obtain the signed acknowledgment. The “reasonable efforts” policy exception for telephone sales does not apply to other types of transactions, such as mail solicitations, in which a covered person must obtain from the consumer a written (in electronic or paper form) acknowledgment.

*Appropriate form or format for acknowledgment provided electronically.* Electronic acknowledgments are not required to be in a specific format but must be consistent with the provisions of the CPSI regulation applicable to consumer acknowledgments. That is, the electronic acknowledgment must establish that the consumer has acknowledged receipt of the credit and insurance disclosures, as applicable.

*Retention of acknowledgments by an insurance company.* If an insurance company provides the disclosures and obtains the acknowledgment on behalf of a depository institution, the insurance company may retain the acknowledgment. The depository institution is responsible for ensuring that sales made “on behalf of” the depository institution are in compliance with the CPSI regulation. An insurance company may maintain documentation showing compliance with the CPSI regulation, but the depository institution should have access to such records and the records should be readily available for review by examiners.

*Form of written acknowledgment.* There is no prescribed form for the written acknowledg-

ment. The regulation requires, however, that a covered person obtain the consumer's acknowledgment of receipt of the complete insurance and credit disclosures.

*Timing of acknowledgment receipt.* A covered person must obtain the consumer's acknowledgment either at the time a consumer receives disclosures or at the time of the initial purchase of an insurance product.

*Oral acknowledgment of oral disclosure.* The CPSI regulation does not prescribe any specific wording for an oral acknowledgment. However, if a covered person has made the insurance and credit disclosures orally, an affirmative response to the question "Do you acknowledge that you received this disclosure?" is acceptable.

## Scope of the CPSI Regulation

### *Applicability to Private Mortgage Insurance*

Depending on the nature of a depository institution's involvement in an insurance sales transaction, the CPSI regulation may cover sales of private mortgage insurance. If the depository institution itself purchases the insurance to protect its interest in mortgage loans it has issued and merely passes the costs of the insurance on to the mortgage borrowers, the transaction is not covered by the regulation. If, however, a consumer has the option of purchasing the private mortgage insurance and (1) the depository institution offers the private mortgage insurance to a consumer or (2) any other person offers the private mortgage insurance to a consumer at an office of a depository institution, or on behalf of a depository institution, the transaction would be covered by the regulation.

### *Applicability to Federal Crop Insurance*

The CPSI regulation does not apply to federal crop insurance that is sold for commercial or business purposes. However, if the crop insurance is purchased by an individual primarily for family, personal, or household purposes, it would be covered.

### *Solicitations and Applications Distributed Before, but Returned After, the Effective Date of the CPSI Regulation*

Direct-mail solicitations and "take-one" applications that are distributed on or after October 1, 2001, must comply with the CPSI regulation. If a consumer seeks to purchase insurance after the effective date of the regulation in response to a solicitation or advertisement that was distributed before that date, the depository institution would be in compliance with the regulation if the institution provides the consumer, before the initial sale, with the disclosures required by the regulation. These disclosures must be both written and oral, except that oral disclosures are not required if the consumer mails in the application.

### *Renewals of Insurance*

Renewals of insurance are not subject to the disclosure requirements (see "Disclosures" above) but are subject to other requirements of the CPSI regulation. A "renewal" of insurance means continuation of coverage involving the same type of insurance for a consumer as issued by the same carrier. A renewal need not be on the same terms and conditions as the original policy, provided that the renewal does not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the time of the initial sale. An upgrade in coverage at a time when a policy is not up for renewal would be treated as a renewal, provided that the solicitation and sale of the upgrade does not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the initial sale.

### *Disclosures Required with Renewals of Insurance Coverage*

The banking agencies' interpretations clarified that the CPSI regulation does not *mandate* disclosures for renewals of policies sold before October 1, 2001. Accordingly, the regulation does not require the disclosures to be furnished at the time of renewal of a policy, including a pre-existing policy. However, renewals are subject to the other provisions of the regulation. Moreover, the banking agencies would expect that, consistent with applicable safety-and-

soundness requirements, depository institutions would take reasonable steps to avoid customer confusion in connection with renewals of pre-existing policies.

### *“On-Behalf-of” Test and Use of Corporate Name or Logo*

Under the CPSI regulation, an affiliate of a bank is not considered to be acting “on behalf of” a bank simply because the affiliate’s marketing or other materials use a corporate name or logo that is common to the bank and the affiliate. In general, this exclusion applies even if a bank and its parent holding company have a similar, but not identical, name. For example, if the names of all of the affiliates of a bank holding company share the words “First National,” an affiliate would not be considered to be engaged in an activity “on behalf of” an affiliated bank simply by using the terms “First National” as part of a corporate logo or identity. The affiliate would, however, be considered to be acting “on behalf of” an affiliated bank if the name of the bank (for example, “First National Bank”) appears in a document as the seller, solicitor, advertiser, or offeror of insurance. A transaction also would be covered if it occurs on the premises of a depository institution or if one of the other prongs of the “on-behalf-of” test is met.

## Compliance

### *Appropriate Documentation of an Oral Disclosure or Oral Acknowledgment*

There is no specific documentation requirement for oral disclosures or acknowledgments. However, other applicable regulatory reporting standards would apply. Appropriate documentation of an oral disclosure would clearly show that the covered person made the credit and insurance disclosures to a consumer. Similarly, appropriate documentation of an oral acknowledgment would clearly show that the consumer acknowledged receiving the credit and insurance disclosures. For example, a tape recording of the conversation (where permitted by applicable laws) in which the covered person made the oral disclosures and received the oral acknowledgment would be acceptable. Another example would

be a contemporaneous checklist completed by the covered person to indicate that he or she made the oral disclosures and received the oral acknowledgment. A contemporaneous note to the consumer’s file would also be adequate. The documentation should be maintained in the consumer’s file so that it is accessible to examiners.

### *Setting for Insurance Sales*

A depository institution must identify the areas where insurance sales occur and must clearly delineate and distinguish those areas from areas where the depository institution’s retail deposit-taking activities occur. Although the banking agencies did not define how depository institutions could “clearly delineate and distinguish” insurance areas, signage or other means may be used.

## APPENDIX B—GLOSSARY

For additional definitions of insurance terms, see section 4040.1.

*Accident and health insurance.* A type of coverage that pays benefits in case of sickness, accidental injury, or accidental death. This coverage may provide for loss of income when the insured is disabled and provides reimbursement for medical expenses when the insured is ill. The insurance can provide for debt payment if it is taken out in conjunction with a loan. (See *Credit life insurance*.)

*Actuary.* A professional whose function is to calculate statistically various estimates for the field of insurance, including the estimated risk of loss on an insurable interest and the appropriate level for premiums and reserves.

*Admitted insurer.* An insurance company licensed by a state insurance department to underwrite insurance products in that state.

*Agency contract (or agreement).* An agreement that establishes the contractual relationship between an agent and an insurer.

*Agent.* A licensed insurance company representative under contract to one or more insurance companies. Depending on the line of insurance



represented, an agent's power may include soliciting, advertising, and selling insurance; collecting premiums; claims processing; and effecting insurance coverage on behalf of an insurance underwriter. Agents are generally compensated by commissions on policies sold, although some may receive salaries.

- *Captive or exclusive agent.* An agent who represents a single insurer.
- *General agent.* An agent who is contractually awarded a specific geographic territory for an individual insurance company. They are responsible for building their own agency and usually represent only one insurer. Unlike exclusive agents, who usually receive a salary in addition to commissions, general agents are typically compensated on a commission basis only.
- *Independent agent.* An agent who is under contractual agreements with at least two different insurers. Typically, all of the independent agent's compensation originates from commissions.

*Aggregate excess-of-loss reinsurance.* A form of "excess-of-loss" reinsurance that indemnifies the ceding company against the amount by which all of the ceding company's losses incurred during a specific period (usually 12 months) exceed either (1) a predetermined dollar amount or (2) a percentage of the company's subject premiums. This type of contract is also commonly referred to as *stop-loss reinsurance* or *excess-of-loss ratio reinsurance*.

*Allied lines.* Various insurance coverages for additional types of losses and against losses by additional perils. The coverages are closely associated with and usually sold with fire insurance. Examples include coverage against loss by perils other than fire, coverage for sprinkler-leakage damage, and business-interruption coverage.

*Annuity.* A contract that provides for a series of payments payable over an individual's life span or other term, on the basis of an initial lump-sum contribution or series of payments made by the annuitant into the annuity during the accumulation phase of the contract.

- *Fixed-annuity contracts* provide for payments

to annuitants at fixed, guaranteed minimum rates of interests.

- *Variable-annuity contracts* provide for payments based on the performance of annuity investments. Variable-annuity contracts are usually sold based on a series of payments and offer a range of investment or funding options, such as stocks, bonds, and money market fund investments. The annuity principal and the investment return are not guaranteed as they depend on the performance of the underlying funding option.

Annuity payments may commence with the execution of the annuity contract (*immediate annuity*) or may be deferred until some future date (*deferred annuity*).

*Assigned risk.* A risk that is not usually acceptable to insurers and is therefore assigned to a group of insurers who are required to share in the premium income and losses, in accordance with state requirements, in order for the insurer to sell insurance in the state.

*Assignment.* The legal transfer of one person's interest in an insurance policy to another person or business.

*Bank-owned life insurance (BOLI).* Life insurance purchased and owned by a bank to fund its exposure arising from employee compensation and benefit programs. In a typical BOLI program, a bank insures a group of employees; pays the life insurance policy premiums; owns the cash values of the policies, which are booked on the bank's balance sheet as "other assets"; and is the beneficiary of the policies upon the death of any insured employee or former employee. (See SR-04-19 and section 4042.1.)

*Beneficiary.* The person or entity named in an insurance policy as the recipient of insurance proceeds upon the policyholder's death or when an endorsement matures. A revocable beneficiary can be changed by the policyholder at any time. An irrevocable beneficiary can be changed by the policyholder only with the written permission of the beneficiary.

*Binder.* A written or oral agreement, typically issued by an insurer, agent, or broker for property and casualty insurance, to indicate acceptance of a person's application for insurance and

to provide interim coverage pending the insurance company's issuance of a binding policy.

**Blanket bond.** Coverage for an employer for loss incurred as a result of employee dishonesty.

**Boiler and machinery insurance.** Insurance against the sudden and accidental breakdown of boilers, machinery, and electrical equipment, including coverage for damage to the equipment and property damage, including the property of others. Coverage can be extended to cover consequential losses, including loss from interruption of business.

**Broker.** A person who represents the insurance buyer in the purchase of insurance. Brokers do not have the power to bind an insurance company to an insurance contract. Once a contract is accepted, the broker is compensated for the transaction through a commission from the insurance company. An individual may be licensed as both a broker and an agent.

**Bulk reinsurance.** A transaction sometimes defined by statute as any quota-share, surplus aid, or portfolio reinsurance agreement through which an insurer assumes all or a substantial portion of the liability of the reinsured company.

**Captive insurer.** An insurance company established by a parent firm to insure or reinsure its own risks or the risks of affiliated companies. A captive may also underwrite insurable risks of unaffiliated companies, typically the risks of its customers or employees. A captive insurer may underwrite credit life or private mortgage insurance (third-party risks) related to its lending activities.

**Cash surrender value of life insurance.** The amount of cash available to a life insurance policyholder upon the voluntary termination of a life insurance policy before it becomes payable by death or maturity.

**Casualty insurance.** Coverage for the liability arising from third-party claims against the insured for negligent acts or omissions causing bodily injury or property damage.

**Cede.** To transfer to a reinsurer all or part of the insurance or reinsurance risk underwritten by an insurance company.

**Ceding commission.** The fee paid to a reinsurance company for assuming the risk of a primary insurance company.

**Ceding company (also cedant, reinsured, reas-sured).** The insurer that transfers all or part of the insurance or reinsurance risk it has underwritten to another insurer or reinsurer via a reinsurance agreement.

**Cession.** The amount of insurance risk transferred to the reinsurer by the ceding company.

**Churning.** The illegal practice wherein a customer is persuaded to unnecessarily cancel one insurance policy in favor of buying a purportedly superior policy, often using the cash surrender value of the existing policy to pay the early premiums of the new policy. In such a transaction, the salesperson benefits from the additional commission awarded for booking a new policy.

**Claim.** A request for payment of a loss under the terms of a policy. Claims are payable in the manner suited to the insured risk. Life, property, casualty, health, and liability claims generally are paid in a lump sum after the loss is incurred. Disability and loss-of-time claims are paid periodically during the period of disability or through a discounted lump-sum payment.

**Coinsurance.** A provision in property and casualty insurance that requires the insured to maintain a specified amount of insurance based on the value of the property insured. Coinsurance clauses are also found in health insurance and require the insured to share a percentage of the loss.

**Combination-plan reinsurance.** A reinsurance agreement that combines the excess-of-loss and the quota-share forms of coverage within one contract, with the reinsurance premium established as a fixed percentage of the ceding company's subject premium. After deducting the excess recovery on any one loss for one risk, the reinsurer indemnifies the ceding company on the basis of a fixed quota-share percentage. If a loss does not exceed the excess-of-loss retention level, only the quota-share coverage applies.

*Commission.* The remuneration paid by insurance carriers to insurance agents and brokers for the sale of insurance and annuity products.

*Comprehensive personal liability insurance.* A type of insurance that reimburses the policyholder if he or she becomes liable to pay money for damage or injury he or she has caused to others. This coverage does not include automobile liability but does include almost every activity of the policyholder, except business operations.

*Contractholder.* The person, entity, or group to whom an annuity is issued.

*Credit for reinsurance.* A statutory accounting procedure, set forth under state insurance regulations, that permits a ceding company to treat amounts due from reinsurers as assets, or as offsets to liabilities, on the basis of the reinsurer's status.

*Credit life insurance.* A term insurance product issued on the life of a debtor that is tied to repayment of a specific loan or indebtedness. Proceeds of a credit life insurance policy are used to extinguish remaining indebtedness at the time of the borrower's death. The term is applied broadly to other forms of credit-related insurance that provide for debt satisfaction in the event of a borrower's disability, accident or illness, and unemployment. Credit life insurance has historically been among the most common bank insurance products.

*Credit score.* A number that is based on an analysis of an individual's credit history and that insurers may consider as an indicator of risk for purposes of underwriting insurance. Where not prohibited by state law, insurers may consider a person's credit history when underwriting personal lines.

*Debt-cancellation contract/debt-suspension agreement.* A loan term or contract between a lender and borrower whereby, for a fee, the lender agrees to cancel or suspend payment on the borrower's loan in the event of the borrower's death, serious injury, unemployment, or other specified events. The Office of the Comptroller of the Currency considers these products to be banking products. State law determines whether these products are bank or insurance products for state-chartered banks and insurance companies.

*Deductible.* The amount a policyholder agrees to pay toward the total amount of insurance loss. The deductible may apply to each claim for a loss occurrence, such as each automobile accident, or to all claims made during a specified period, as with health insurance.

*Directors and officers liability insurance.* Liability insurance covering a corporation's obligation to reimburse its directors or officers for claims made against them for alleged wrongful acts. It also provides direct coverage for company directors and officers themselves in instances when corporate indemnification is not available.

*Direct premiums written.* Premiums received by an underwriter for all policies written during a given time period by the insurer, excluding those received through reinsurance assumed.

*Direct writer.* An insurance company that deals directly with the insured through a salaried representative, as opposed to those insurers that use agents. This term also refers to insurers that operate through exclusive agents. In reinsurance, a direct writer is the company that originally underwrites the insurance policies ceded.

*Disability income insurance.* An insurance product that provides income payment to the insured when his or her income is interrupted or terminated because of illness or accident.

*Endowment insurance.* A type of life insurance contract under which the insured receives the face value of the policy if he or she survives the endowment period. Otherwise, the beneficiary receives the face value of the policy upon the death of the insured.

*Errors and omissions (E&O) liability insurance.* Professional liability insurance that covers negligent acts or omissions resulting in loss. Insurance agents are continually exposed to the claim that inadequate or inappropriate coverage was recommended, resulting in a lack of coverage for losses incurred. The agent or the carrier may be responsible for coverage for legitimate claims.

*Excess-of-loss reinsurance.* A form of reinsurance whereby an insurer pays the amount of each claim for each risk up to a limit determined in advance, and the reinsurer pays the amount of the claim above that limit up to a specific sum. It includes various types of reinsurance, such as

catastrophe reinsurance, per-risk reinsurance, per-occurrence reinsurance, and aggregate excess-of-loss reinsurance.

*Excess-per-risk reinsurance.* A form of excess-of-loss reinsurance that, subject to a specified limit, indemnifies the ceding company against the amount of loss in excess of a specified retention for each risk involved in each occurrence.

*Excess and surplus lines.* Property/casualty coverage that is unavailable from insurers licensed by the state (admitted insurers) and must be purchased from a nonadmitted underwriter.

*Exposure.* The aggregate of all policyholder limits of liability arising from policies written.

*Face amount.* The amount stated on the face of the insurance policy to be paid, depending on the type of coverage, upon death or maturity. It does not include dividend additions or additional amounts payable under accidental death or other special provisions.

*Facultative reinsurance.* Reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the faculty to accept or reject each risk offered by the ceding company.

*Facultative treaty.* A reinsurance contract under which the ceding company has the option to cede and the reinsurer has the option to accept or decline classified risks of a specific business line. The contract merely reflects how individual facultative reinsurance shall be handled.

*Financial guarantee insurance.* Financial guarantee insurance is provided for a wide array of financial risks. Typically, coverage is provided for the fulfillment of a specific financial obligation originated in a business transaction. The insurer, in effect, is lending the debtor its own credit rating to enhance the debtor's creditworthiness.

*Financial strength rating.* Opinion as to an insurance company's ability to meet its senior policyholder obligations and claims. For many years, the principal rating agency for property and casualty insurers and life insurers has been A.M. Best. Other rating agencies, such as Fitch, Moody's, Standard and Poor's, and Weiss, also rate insurers.

*Fixed annuity.* See *Annuity*.

*Flood insurance.* A special insurance policy to protect against the risk of loss or damage to property caused by flooding. Regular homeowners' policies do not pay for damages caused by flooding.

*General liability insurance.* A broad commercial policy that covers all business liability exposures, such as product liability, completed operations, premises and operations, independent contractors, and other exposures that are not specifically excluded.

*Gross premiums written.* Total premiums for insurance written during a given period, before deduction for reinsurance ceded.

*Group insurance.* Insurance coverage typically issued to an employer under a master policy for the benefit of employees. The insurer usually does not condition coverage of the people that make up the group upon satisfactory medical examinations or other requirements. The individual members of the group hold certificates as evidence of their insurance.

*Health insurance.* An insurance product that provides benefits for medical expenses incurred as a result of sickness or accident, as well as income payments to replace lost income when the insured is unable to work because of illness, accident, or disability. This product may be in the form of traditional indemnity insurance or managed-care plans and may be underwritten on an individual or group basis.

*Incurred but not reported (IBNR).* The loss-reserve value established by insurance and reinsurance companies in recognition of their liability for future payments on losses that have occurred but have not yet been reported to them. This definition is often erroneously expanded to include adverse loss development on reported claims. The term *incurred but not enough reported (IBNER)* is being increasingly used to reflect more accurately the adverse development on inadequately reserved reported claims.

*Inland marine insurance.* A broad field of insurance that covers cargo being shipped by air, truck, or rail. It includes coverage for most property involved in transporting cargo as well as for bridges, tunnels, and communications systems.

*Key person life insurance.* Life insurance designed to cover the key employees of an employer. It may be written on a group- or an individual-policy basis.

*Lapse.* The termination or discontinuance of a policy resulting from the insured's failure to pay the premium due.

*Liability insurance.* Protects policyholders from financial loss due to liability resulting from injuries to other persons or damage to their property.

*Lines.* A term used in insurance to denote insurance business lines, as in "commercial lines" and "personal lines."

*Long-term care insurance.* Health insurance designed to supplement the cost of nursing home care or other care facilities in the event of a long-term illness or permanent disability or incapacity.

*Managing general agent.* A managing general agent (MGA) is a wholesaler of insurance products and services to insurance agents. An MGA receives contractual authority from an insurer to assume many of the insurance company's functions. The MGA may provide insurance products to the public through local insurance agents as well as provide services to an insurance company, including marketing, accounting, data processing, policy maintenance, and claims-monitoring and -processing services. Many insurance companies prefer the MGA distribution and management system for their insurance products because it avoids the high cost of establishing branch offices. Most states require that an MGA be licensed.

*Manuscript policy.* A policy written to include specific coverage or conditions not provided in a standard policy.

*Morbidity.* The incidence and severity of illness and disease in a defined class of insured persons.

*Mortality.* The rate at which members of a group die in a specified period of time or die from a specific illness.

*Mortgage guarantee insurance.* A product that insures lenders against nonpayment by borrowers. The policies are issued for a specified time

period. Lenders who finance more than 80 percent of the property's fair value generally require such insurance.

*Mortgage insurance.* Life insurance that pays the balance of a mortgage even if the borrower dies. Coverage typically is in the form of term life insurance, with the coverage declining as the debt is paid off.

*Multiperil insurance.* An insurance contract providing coverage against many perils, usually combining liability and physical damage coverage.

*Net premiums written.* The amount of gross premiums written, after deduction of premiums ceded to reinsurers.

*Ninety-day loss rule.* A state requirement for an insurer to establish a loss provision for reinsurance recoverables over 90 days past due.

*Obligatory treaty.* A reinsurance contract under which business must be ceded in accordance with contract terms and must be accepted by the reinsurer.

*Policyholder.* The person or entity who owns an insurance policy. This is usually the insured person, but it may also be a relative of the insured, a partnership, or a corporation.

*Premium.* The payment, or one of the periodic payments, a policyholder agrees to make for insurance coverage.

*Private mortgage insurance (PMI).* Coverage for a mortgage lender against losses due to a collateral shortfall on a defaulted residential real estate loan. Most banks require borrowers to take out a PMI policy if a downpayment of less than 20 percent of a home's value is made at the time the loan is originated. PMI does not directly benefit a borrower, although its existence provides the opportunity to purchase a home to many people who otherwise would not qualify for a loan.

*Producer.* A person licensed to sell, solicit, or negotiate insurance.

*Professional designations and organizations.* Three of the most common insurance professional designations are chartered life under-

writer (CLU), chartered property casualty underwriter (CPCU), and chartered financial consultant (ChFC). Insurance agents also join professional organizations such as the American Society of Chartered Life Underwriters, the International Association of Financial Planning, the National Association of Life Underwriters, the National Association of Health Underwriters, the American Council of Life Insurance, the Life Insurance Marketing and Research Association, the Life Underwriter Training Council, and the Million Dollar Round Table.

*Pro rata reinsurance.* A generic term describing all forms of “quota-share” and “surplus reinsurance,” in which the reinsurer shares a pro rata portion of the losses and premiums of the ceding company.

*Property insurance.* Coverage for physical damage or destruction of real property (buildings, fixtures, and permanently attached equipment) and personal property (movable items that are not attached to land) that occurs during the policy period as a result of, for example, fire, windstorm, explosion, or vandalism.

*Protected cell.* A structure available to captive insurers underwriting risks of unaffiliated companies whereby the assets associated with the self-insurance program of one organization are segregated to provide legal-recourse protection from creditors of protected cells providing insurance coverage to other organizations.

*Quota-share reinsurance.* A form of pro rata reinsurance indemnifying the ceding company for a fixed percent of loss on each risk covered in the contract in consideration of the same percentage of the premium paid to the ceding company.

*Rebating.* Directly or indirectly giving or offering to give any portion of the premium or any other consideration to an insurance buyer as an inducement to purchase or renew the insurance. Rebates are forbidden under most state insurance codes.

*Reinsurance.* Insurance placed by an underwriter (the ceding company or reinsured) in another company to transfer or reduce the amount of the risk assumed under the original insurance policy (or group of policies).

*Reinsurance premium.* The consideration paid by a ceding company to a reinsurer for the coverage provided by the reinsurer.

*Residual market.* Also known as the shared market, it covers applications for insurance that were rejected by underwriters in the voluntary market that is covered by agency direct-marketing systems, perhaps because of high loss experience by the insured party. The residual market includes government insurance programs, specialty pools, and shared market mechanisms such as assigned-risk plans.

*Retrocession.* A reinsurance transaction whereby a reinsurer (the retrocedant) cedes all or part of the reinsurance risks it has assumed to another reinsurer (the retrocessionaire).

*Retrospective rating.* An insurance plan in which the current year’s premium is based on the insured’s own loss experience for that same period, subject to a maximum and minimum.

*Rider.* A written attachment, also known as an endorsement, to an insurance policy that changes the original policy to meet specific requirements, such as increasing or decreasing benefits or providing coverage for specific property items beyond that provided for under the insurance company’s standard contract terms.

*Self-insured retention (SIR).* The percentage of a risk or potential loss assumed by an insured, whether in the form of a deductible, self-insurance, or no insurance at all.

*Separate accounts.* Certain life insurance assets and related liabilities that are segregated and maintained to meet specific investment objectives of contract holders, particularly those assets and liabilities associated with pension plans and variable products offered by life insurers, wherein the customer and not the insurer retains most of the investment and interest-rate risk.

*Split-dollar life insurance.* An arrangement that typically involves an agreement between an employer and an employee whereby the premium payment, cash values, policy ownership, and death benefits may be split. There are many variations of split-dollar arrangements, including arrangements in which a trust is created to facilitate estate planning. Split-dollar life insurance is designed to serve as a supplemental

benefit to a particular company executive. The arrangement typically involves the payment of the insurance premium by the employer, with the death benefit accruing to the employee.

*Subrogation.* An insurance carrier may reserve the “right of subrogation” in the event of a loss. This means that the company may choose to take action to recover the amount of a claim paid to a covered insured if a third party caused the loss. After expenses, the amount recovered must be divided proportionately with the insured to cover any deductible for which the insured was responsible.

*Term life insurance.* An insurance product that provides, for a specified period of time, death coverage only. Typically, it has no savings component and, therefore, no cash value. Because term insurance provides only mortality protection, it generally provides the most coverage per premium dollar. Most term life insurance policies are renewable for one or more time periods up to a stipulated maximum age; however, premiums generally increase with the age of the policyholder.

*Title insurance.* Insurance that protects banks and mortgagees against unknown encumbrances against real estate by indemnifying the mortgagor and property owner in the event that clear ownership of the property is clouded by the discovery of faults in the title. Title insurance policies may be issued to either the mortgagor or the mortgagee or both. Title insurance is written largely only by companies specializing in this class of insurance.

*Treaty reinsurance.* A reinsurance contract under which the reinsured company agrees to cede, and the reinsurer agrees to assume, risks of a particular class or classes of business.

*Twisting.* In insurance, twisting involves making misrepresentations to a policyholder to induce the policyholder to terminate one policy and take out another policy with another company, when it is not to the insured’s benefit. Twisting is a violation of the Unfair Trade Practices Act. Twisting is similar to the “churning” concept in securities sales, and it results in increased commissions for the inducing agent.

*Umbrella liability insurance.* This type of liability insurance provides excess liability protection

over the “underlying” liability insurance coverage to supplement underlying policies that have been reduced or exhausted by loss.

*Underwriting.* The process by which a company determines whether it can accept an application for insurance and by which it may charge an appropriate premium for those applications selected. For example, the underwriting process for life insurance classifies applicants by identifying such characteristics as age, sex, health, and occupation.

*Unearned reinsurance premium.* The part of the reinsurance premium that is applicable to the unexpired portion of the policies reinsured.

*Universal life insurance.* A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a high cash surrender value. Alternatively, the policyholder can make minimal payments in an amount only large enough to cover mortality and other expense charges.

*Variable annuity.* See *Annuity*.

*Variable life insurance.* A form of whole life, or universal life, insurance in which the policyholder’s cash value is invested in “separate accounts” of the insurer. These accounts are segregated from the insurance carrier’s other asset holdings. Such separate account investments are generally not available to a carrier’s general creditors in the event of the carrier’s insolvency. The policyholder assumes the investment and price risk. Because variable life policies have investment features, life insurance agents selling these policies must be registered representatives of a broker-dealer licensed by the Financial Industry Regulatory Authority and registered with the Securities and Exchange Commission.

*Vendors’ single-interest insurance.* A form of force-placed insurance that is typically purchased by the bank to protect against loss or damage to loan collateral in which the bank has a security interest. The bank passes its expense for this insurance on to the consumer who has either refused or is unable to obtain property insurance.

*Viatical settlement.* The cashing in of a life insurance policy at a discount from face amount

by policyholders who are often terminally ill and need the money for medical care. The purchaser becomes the policyholder as well as the beneficiary and assumes the premium payments of the policy.

*Whole life insurance.* A fixed-rate insurance product, with premiums and death benefits guaranteed over the duration of the policy. There is

a cash value (essentially a savings account) that accrues to the policyholder tax deferred. A policyholder receives the cash value in lieu of death benefits if the policy matures or lapses before the insured's death. A policyholder also may borrow against the policy's accumulated cash value or use it to pay future premiums. For most whole life insurance policies, premiums are constant for the life of the insured's contract.



# Insurance Sales Activities and Consumer Protection in Sales of Insurance

## Examination Objectives

Effective date November 2003

## Section 4043.2

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1. To understand the volume and complexity of the state member bank's insurance or annuity program and insurance sales strategy.
  2. To assess the financial results of the insurance and annuity sales activity compared with planned results.
  3. To determine if the state member bank's insurance and annuity sales activities are effectively integrated into the risk-management, audit, and compliance functions and if the control environment is adequate.
  4. To assess the adequacy of the state member bank's controls to ensure compliance with the applicable state and federal laws and regulations.
  5. To assess the state member bank's level and direction of operational, legal, and reputational risks from the insurance or annuity sales activity.
- The following objectives apply if insurance products or annuities are sold by a bank or another person at an office of, or on behalf of, the bank.*
6. To assess the adequacy of the state member bank's oversight program for ensuring compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation. (See section 4043.1.)
  7. To assess the effectiveness of the state member bank's audit and compliance programs for the CPSI regulation.
  8. To assess the state member bank's current compliance with the CPSI regulation.
  9. To obtain commitments for corrective action when the state member bank is in violation of the CPSI regulation or when applicable policies, procedures, practices, or management oversight to protect against violations is deficient.

# Insurance Sales Activities and Consumer Protection in Sales of Insurance

## Examination Procedures

Effective date November 2003

## Section 4043.3

### RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

The examiner should consider the following procedures, as appropriate, when conducting a risk assessment to determine the level and direction of risk exposure to the state member bank that is attributable to insurance or annuity sales activity. If there are specific areas of concern, the examiner should focus primarily on those areas.

1. *Scope of activities and strategies.* Assess the significance and complexity of the insurance or annuity sales program.

- a. Obtain a general overview of the scope of the state member bank's insurance or annuity sales activities and any anticipated or recent change in or expansion of such activities.
- b. Determine the state member bank's strategy for insurance or annuity sales, including strategies for cross-selling and referrals of insurance and banking products. Determine the institution's experience with any cross-marketing programs for both insurance business generated by the bank and bank business generated by insurance producers.
- c. Obtain two years' worth of income statements, balance sheets, and budget documents for the agency's activities. Compare the expected budget items with their actual results.
- d. Determine the volume and type of insurance or annuity products and services sold or solicited.
- e. Determine what other related services the state member bank provides in connection with its insurance or annuity sales activities, such as providing risk-management services to clients seeking advice on appropriate insurance coverages, claims processing, and other activities.

2. *Insurance sales products and concentrations.*

- a. Determine the composition of sales—
  - by line of business, such as property/casualty insurance, life insurance

including annuities, and health insurance;

- by the proportion of sales to commercial and retail customers; and
  - by the portion of sales that is credit related, such as credit life and credit health insurance.
- b. Determine any sales concentrations to particular entities, industries, or bank customers.
  - c. Note any concentrations to large commercial accounts.
  - d. Determine what insurance services are provided to the bank, its employees, and bank affiliates.
3. *Legal-entity and risk-management structure for insurance or annuity sales.*
- a. Obtain an organizational chart for the legal-entity and risk-management structure for the insurance or annuity sales activities.
  - b. Determine—
    - whether the insurance or annuity sales activity is conducted in an affiliated producer, by the bank itself, through another distribution arrangement, or by a combination of these arrangements;
    - the names of any affiliated insurance agencies and the states where the affiliated insurance agencies are licensed;
    - the locations outside of the United States where insurance or annuities are sold or solicited; and
    - if any subsidiary agency operates as a financial subsidiary under the Gramm-Leach-Bliley Act.
  - c. Determine if the insurance or annuity producer is acting as a managing general agent (MGA).<sup>1</sup> If so, determine—
    - the scope of the MGA activities;
    - the state member bank management's

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1. MGAs do not assume underwriting risk. Through contractual arrangements with an insurer, MGAs have the authority to write policies on behalf of the insurer in certain instances, thereby binding the insurer to the policy. Certain minimum provisions governing MGA agreements are delineated in the applicable National Association of Insurance Commissioners (NAIC) model law.

- assessment of the risk associated with the MGA activity; and
- what risk controls are in place to protect the state member bank from potential loss that may arise from the MGA's activities, such as loss arising from legal liability.
4. *Strategic and financial plans.* Assess management controls over the insurance and annuity sales activities.
    - a. Ascertain the state member bank management's strategic and financial plans and goals for the insurance or annuity sales activity.
    - b. Review the state member bank's due-diligence process for acquiring and pricing agencies, if applicable.
    - c. Review the state member bank's financial budgets and forecasts for the activity, particularly plans for new products, marketing strategies and marketing arrangements, and the rate of actual and expected growth for the activity.
    - d. Determine the cause for significant deviations from the plan.
    - e. Determine if any agency acquired by the state member bank is providing the expected return on investment and if the agency's revenues are covering the debt servicing associated with the purchase, if applicable.
  5. *Review of board and committee records and reports.*
    - a. Review the reports of any significant state member bank oversight committees, including relevant board of directors and board committee minutes and risk-management reports.
    - b. Determine if the board of directors, a board committee, or senior management of the state member bank reviews reports pertaining to consumer complaints and complaint resolution, information pertaining to litigation and associated losses, and performance compared with the organization's plan for the insurance and annuity sales activities.
  6. *Policies and procedures.*
    - a. Determine—
      - the adequacy of the state member bank's policies and procedures for conducting and monitoring insurance or annuity sales activities, including those policies designed to ensure adherence with federal and state laws and regulations pertaining to consumer protection;
      - whether there are appropriate policies and procedures for the handling of customer funds collected on behalf of the underwriter; accurate and timely financial reporting; complaint monitoring and resolution; effective system security and disaster-recovery plans; and policy-exception tracking and reporting; and
      - if the board of directors or its designated committee has formally approved the policies.
    - b. Obtain a detailed balance sheet for agency subsidiaries, and determine if the assets held by insurance or annuity agency subsidiaries of the state member bank are all bank-eligible investments.
    - c. Determine the independence of the state member bank's audit program applicable to the insurance and annuity sales activity. Determine if the audit program's scope, frequency, and resources are commensurate with the insurance or annuity sales activities conducted.
    - d. Determine how the state member bank selects insurance underwriters with whom to do business, as well as how the state member bank monitors the continuing performance of the underwriters.
    - e. Determine the adequacy of the oversight of the bank's board of directors over the insurance management team's qualifications, the training and licensing of personnel, and general compliance with state insurance regulations.
    - f. Review the internal controls of the state member bank related to third-party arrangements, including arrangements for sales, processing, and auditing of insurance or annuity sales activities.
  7. *Claims, litigation, and functional regulatory supervision.* Assess legal and reputational risk.
    - a. Identify any significant litigation against the state member bank arising from its insurance or annuity sales activity and the likely impact of the litigation on the state member bank.
    - b. Obtain the insurance agency's errors and omissions claims records for the past several years, including a listing of claims it has made and the amount of claims, the

- claim status, and the amount of claim payments.
- c. Review the state member bank's policies and procedures for tracking and resolving claims. Determine if they appear adequate and if they are adhered to.
  - d. Determine if the applicable functional regulator has any outstanding supervisory issues with the insurance agency.
8. *Consumer complaints.*
    - a. Determine if bank management has policies and procedures in place to assess whether consumer complaints received are likely to expose the state member bank to regulatory action, litigation, reputational damage, or other significant risk.
    - b. Obtain applicable consumer complaint files, and evaluate internal control procedures to ensure the complaints are being adequately addressed.
  9. *Audit and compliance functions.*
    - a. Determine the date of the most recent review of the insurance or annuity sales activities by the audit and compliance functions.
    - b. Determine the adequacy of the state member bank's management policies and procedures for ensuring that any deficiencies noted in such reviews are corrected, and ascertain whether any such deficiencies are being adequately addressed.<sup>2</sup>
  10. *Insurance underwriter oversight of agent/agency activities.*
    - a. Determine if there are adequate policies and procedures to review and resolve any issues or concerns raised by an insurance underwriter regarding the producers used by, or affiliated with, the state member bank.<sup>3</sup>
    - b. Determine whether any of the insurance underwriters conducted a periodic review of the producers that they engaged to sell insurance.
  11. *State supervisory insurance authorities.*
    - a. During discussions with state member bank management, determine whether state insurance regulators have raised any issues or concerns in correspondence or reports.
    - b. Consult with the state insurance regulators, as appropriate, to determine any significant supervisory issues, actions, or investigations. (For multistate agencies, contacts with states may be prioritized on the basis of the location of the agency's head office or by a determination of the significance of sales by state. Both financial examinations and market conduct examinations conducted by the state insurance departments are targeted at insurance underwriters, not agencies. Therefore, information available from the states pertaining to agencies may be very limited.)
  12. *Operational risk assessment.* Ascertain from the state member bank's management whether there are—
    - a. any significant operational problems or concerns relating to insurance or annuity sales activities;
    - b. policies and procedures in place to ensure accurate and timely reporting to the state member bank's management of insurance or annuity sales activity plans, financial results, and significant consumer complaints or lawsuits or compliance issues, such as errors and omissions claims;<sup>4</sup>
    - c. appropriate policies and procedures at the state member bank to ensure accurate reporting of insurance or annuity sales activity on Federal Reserve regulatory reports (Determine from applicable Board or Reserve Bank contacts if there are any outstanding issues with respect to potential reporting errors on submitted Federal Reserve reports, bank call reports, or other applicable reports. If so, seek resolution of the issues.); and
    - d. adequate disaster-recovery plans and procedures to protect the state member bank

2. Enforcement of the privacy provisions of the Gramm-Leach-Bliley Act as they relate to state member banks is the responsibility of the Board's Division of Consumer and Community Affairs. However, enforcement of the privacy provisions of the GLB Act with respect to the insurance activities of nondepository subsidiaries of a state member bank is the responsibility of the state insurance regulators.

3. Insurance underwriters generally have procedures to determine whether individual producers affiliated with agencies are selling the underwriters' products in conformance with applicable laws and regulations. The findings and conclusions of these reviews should be available to the state member bank's management.

4. Errors and omissions insurance should be in place to protect the state member bank against loss sustained because of an error or oversight, such as failure to issue an insurance policy. A tracking system to monitor errors and omission claims should be in place and monitored by the state member bank, as appropriate. See section 4040.1, "Management of Insurable Risks."

from loss of data related to insurance or annuity sales activities.

## CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

The following procedures should be risk-focused in accordance with the Federal Reserve's risk-focused framework for supervising banking organizations. The procedures should be carried out as necessary to adequately assess the state member bank's compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation.

1. Determine the role of the state member bank's board of directors and management in ensuring compliance with the CPSI regulation and applicable state consumer regulations.
2. Evaluate the management information system (MIS) reports the state member bank's board or designated committee rely on to monitor compliance with the consumer regulations and to track complaints and complaint resolution.
3. Review the state member bank's policies and procedures to ensure they are consistent with the CPSI regulation, and conduct transaction testing, as necessary, in the following areas.<sup>5</sup>
  - a. disclosures, advertising, and promotional materials
  - b. consumer acknowledgments
  - c. physical separation from areas of deposit-taking activities
  - d. qualifications and licensing for insurance personnel
  - e. compliance programs and internal audits
  - f. hiring, training, and supervision of insurance or annuity sales personnel employed directly by the bank, or of third parties selling insurance or annuity products at a state member bank office or on behalf of the state member bank
  - g. compensation practices and training for personnel making referrals
4. If a third party sells insurance or annuities at the state member bank's offices, or on behalf of the bank, review the state member bank's policies and procedures for ensuring that the third party complies with the CPSI regulation and other relevant policies and procedures of the bank.
5. Review the bank's process for identifying and resolving consumer complaints related to the sale of insurance products and annuities.
6. Obtain and review the record of consumer complaints related to the CPSI regulation. (These records are available from the Board's Division of Consumer and Community Affairs database. See CP letter 2001-11.)
7. Include examination findings, as appropriate, in the commercial bank examination report or in other communications to the bank, as appropriate, that pertain to safety-and-soundness reviews of the bank.

5. If the examiner determines that transaction testing of a functionally regulated nonbank affiliate of the state member bank is appropriate in order to determine the state member bank's compliance with the CPSI regulation, the examiner should first consult with and obtain approval from appropriate staff of the Board's Division of Banking Supervision and Regulation.

# Insurance Sales Activities and Consumer Protection in Sales of Insurance

## Internal Control Questionnaire

Effective date November 2003

Section 4043.4

### RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

#### Program Management

1. Does the state member bank have a comprehensive program to ensure that its insurance and annuity sales activities are conducted in a safe and sound manner?
2. Does the state member bank have appropriate written policies and procedures commensurate with the volume and complexity of the insurance or annuity sales activities?
3. Has bank management obtained the approval of the bank's board of directors for the program scope and the associated policies and procedures?
4. Have reasonable precautions been taken to ensure that disclosures to customers for insurance or annuity sales and solicitations are complete and accurate, and are in compliance with applicable laws and regulations?
5. Does the state member bank effectively oversee the insurance or annuity sales activities, including those involving third parties?
6. Does the state member bank have an effective independent internal audit and compliance program in place to monitor retail sales of insurance or annuity products?
7. Does the bank appropriately train and supervise employees conducting insurance or annuity sales activities?

#### Management Information Systems

8. Does the state member bank's insurance program management plan establish the appropriate management information systems (MIS) necessary for the board of directors to properly oversee the bank's insurance or annuity sales activities?
9. Does MIS provide sufficient information to allow for the evaluation and measurement of the effect of actions taken to identify, track, and resolve any issues relative to

compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation?

10. Does MIS include sales volumes and trends, profitability, policy exceptions and associated controls, customer complaints, and other information providing evidence of compliance with laws and established policies?

#### Compliance Programs and Internal Audits

11. Are there policies and procedures in place to ensure that insurance or annuity sales activities are conducted in compliance with applicable laws and regulations?
12. Do compliance procedures identify potential conflicts of interest and how such conflicts should be addressed?
13. Do the compliance procedures provide a system to monitor customer complaints and track their resolution?
14. When applicable, do compliance procedures call for verification that third-party sales are being conducted in a manner consistent with the agreement governing the third party's arrangement with the state member bank?
15. Is the compliance function conducted independently of the insurance or annuity sales and management activities?
16. Do compliance personnel determine the scope and frequency of the insurance-product review?
17. Are findings of insurance or annuity sales activity compliance reviews periodically reported directly to the state member bank's board of directors or a designated committee thereof?

### CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

If applicable, review the state member bank's internal controls, policies, practices, and proce-

dures for retail insurance or annuity sales activities conducted by the bank on bank premises or on behalf of the bank. The bank's program management for such activities should be well documented and should include appropriate personnel training, as well as compliance and audit-function coverage of all efforts to ensure compliance with the provisions of the Board's CPSI regulation.

## Advertising and Promotional Materials

1. Do advertising materials associated with the insurance or annuity sales program create an erroneous belief that—
  - a. an insurance product or annuity sold or offered for sale by the state member bank, or on behalf of the bank, is backed by the federal government or the bank, or that the product is insured by the FDIC?
  - b. an insurance product or annuity that involves investment risk does not, in fact, have investment risk, including the potential that principal may be lost and the product may decline in value?
2. Does a review of advertising for insurance products or annuities sold or offered for sale create an erroneous impression that—
  - a. the state member bank or an affiliate or subsidiary may condition the grant of an extension of credit to a consumer on the purchase of an insurance product or annuity by the consumer from the bank or an affiliate or subsidiary of the bank?
  - b. the consumer is not free to purchase an insurance product or annuity from another source?

## Disclosures

3. In connection with the initial purchase of an insurance product or annuity by a consumer, does the initial disclosure to the consumer, except to the extent the disclosure would not be accurate, state that—
  - a. the insurance product or annuity is not a deposit or other obligation of, or is not guaranteed by, the state member bank or an affiliate of the bank?
  - b. the insurance product or annuity is not

- insured by the FDIC or any other agency of the United States, the state member bank, or (if applicable) an affiliate of the bank?
  - c. in the case of an insurance product or annuity that involves an investment risk, there is risk associated with the product, including the possible loss of value?
4. In the case of an application for credit, in connection with which an insurance product or annuity is solicited, offered, or sold, is a disclosure made that the state member bank may not condition an extension of credit on either—
    - a. the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates?
    - b. the consumer's agreement not to obtain, or a prohibition on the consumer's obtaining, an insurance product or annuity from an unaffiliated entity?
  5. Are the disclosures under question 3 above provided orally and in writing before the completion of the initial face-to-face sale of an insurance product or annuity to a consumer?
  6. Are the disclosures under question 4 above made orally and in writing at the time the consumer applies in a face-to-face interaction for an extension of credit in connection with which insurance is solicited, offered, or sold?
  7. If a sale of an insurance product or annuity is conducted by telephone, are the disclosures under question 3 above provided in writing, by mail, within three business days?
  8. If an application for credit is by telephone, are the disclosures under question 4 above provided by mail to the consumer within three business days?
  9. Are the disclosures under questions 3 and 4 above provided through electronic media, instead of on paper, only if the consumer affirmatively consents to receiving the disclosures electronically, and only if the disclosures are provided in a format that the consumer may retain or obtain later?
  10. Are disclosures made through electronic media, for which paper or oral disclosures are not required, presented in a meaningful form and format?
  11. Are disclosures conspicuous, simple, direct, readily understandable, and designed to call attention to the nature and significance of the information provided?

12. Are required disclosures presented in a meaningful form and format?

### Consumer Acknowledgment

13. At the time a consumer receives the required disclosures, or at the time of the consumer's initial purchase of an insurance product or annuity, is a written acknowledgment from the consumer that affirms receipt of the disclosures obtained?
14. If the required disclosures are provided in connection with a transaction that is conducted by telephone—
- has an oral acknowledgment of receipt of the disclosures been obtained, and is sufficient documentation maintained to show that the acknowledgment was given?
  - have reasonable efforts to obtain a written acknowledgment from the consumer been made?

### Physical Separation from Deposit Activities

15. Does the state member bank, to the extent practicable—
- keep the area where the bank conducts transactions involving the retail sale of insurance products or annuities physically segregated from the areas where retail deposits are routinely accepted from the general public?
  - identify the areas where insurance product or annuity sales activities occur?
  - clearly delineate and distinguish insurance and annuity sales areas from the areas where the bank's retail deposit-taking activities occur?

### Qualifications and Licensing

16. Does the state member bank permit any person to sell, or offer for sale, any insurance product or annuity in any part of its office, or on its behalf, only if the person is at all times appropriately qualified and licensed under applicable state insurance licensing standards for the specific products being sold or recommended?

### Hiring, Training, and Supervision

17. Have background investigations of prospective employees that will sell insurance products or annuities been completed?
18. When a candidate for employment has previous insurance experience, has a review to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators been completed?
19. Do all insurance or annuity sales personnel, or third-party sales personnel conducting sales activities at or on behalf of the state member bank, receive appropriate training and continue to meet licensing requirements?
20. Does training address policies and procedures for sales of insurance and annuity products, and does it cover personnel making referrals to a licensed insurance producer?
21. Does training ensure that personnel making referrals about insurance products or annuities are properly handling all inquiries so as not to be deemed to be acting as unlicensed insurance agents or registered (or equivalently trained) securities sales representatives (for insurance products that are also securities) if they are not qualified?
22. When insurance products or annuities are sold by the state member bank or third parties at an office of, or on behalf of, the organization, does the institution have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as the referral activities of bank employees not authorized to sell these products?
23. Does the bank designate supervisory personnel responsible for monitoring compliance with any third-party agreement, as well as with the CPSI regulation?

### Referrals

24. Are fees paid to nonlicensed personnel who are making referrals to qualified insurance or annuity salespersons limited to a one-time, nominal fee of a fixed dollar amount for each referral, and is the fee unrelated to whether the referral results in a sales transaction?



### Third-Party Agreements

25. Does the state member bank's management conduct a comprehensive review of a third party before entering into any arrangement to conduct insurance or annuity sales activities through the third party?
26. Does the review include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including compliance with applicable consumer protection laws and regulation?
27. Does the board of directors or a designated committee thereof approve any agreement with the third party?
28. Does the agreement outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the bank's office space, equipment, and personnel?
29. Does the third-party agreement specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable?
30. Does the agreement authorize the bank to monitor a third party's compliance with the agreement, as well as to have access to third-party records considered necessary to evaluate compliance?
31. Does the agreement provide for indemnification of the institution by the third party for any losses caused by the conduct of the third party's employees in connection with its insurance or annuity sales activities?
32. If an arrangement includes dual employees, does the agreement provide for written employment contracts that specify the duties of these employees and their compensation arrangements?
33. If the state member bank contracts with a functionally regulated third party, does the bank obtain, as appropriate, any relevant regulatory reports of examination of the third party?
34. How does the state member bank ensure that a third party selling insurance or annuity products at or on behalf of the bank complies with all applicable regulations, including the CPSI regulation?
35. How does the state member bank ensure that any third party or dual employee selling insurance or annuity products at or on behalf of the bank is appropriately trained to comply with the minimum disclosures and other requirements of the Board's CPSI regulation and applicable state regulations?
36. Does the bank obtain and review copies of third-party training and compliance materials to monitor the third party's performance regarding its disclosure and training obligations?

### Consumer Complaints

37. Does the state member bank have policies and procedures for handling customer complaints related to insurance and annuity sales?
38. Does the customer complaint process provide for the recording and tracking of all complaints?
39. Does the state member bank require periodic reviews of complaints by compliance personnel? Is a review by the state member bank's board and senior management required for significant compliance issues that may pose risk to the state member bank?

# Transactions Between Member Banks and Their Affiliates

## Section 4050.1

Effective date October 2010

### SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT AND REGULATION W

*NOTE: Title VI of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Pub. Law. No. 111-203) modifies sections 23A and 23B of the Federal Reserve Act (FRA). Those changes, however, are not effective until July 2012 and are not included in this revised section.*

Section 23A of the FRA (12 USC 371c) is the primary statute governing transactions between a member bank and its affiliates. Section 23A (1) designates the types of companies that are affiliates of a bank; (2) specifies the types of transactions covered by the statute; (3) sets the quantitative limitations on a bank's covered transactions with any single affiliate, and with all affiliates combined; (4) sets forth collateral requirements for certain bank transactions with affiliates; and (5) requires all covered transactions to be conducted on terms consistent with safe and sound banking practices.

In addition to the statutory provisions of section 23A, the Board approved the issuance of Regulation W, which became effective April 1, 2003, implementing changes to sections 23A and 23B of the FRA. To facilitate compliance with these statutes, the rule<sup>1</sup> provides several exemptions and combines the statutory restrictions on transactions between a member bank and its affiliates with numerous Board interpretations and exemptions that were previously issued.

### Quantitative Limits

Section 23A (a)(1)(A) states that a member bank<sup>2</sup> may engage in a covered transaction with

an affiliate only if, in the case of any affiliate, the bank limits the aggregate amount of covered transactions to that particular affiliate to not more than 10 percent of the member bank's capital stock and surplus. Sections 223.11 and 223.12 of the rule sets forth these quantitative limits. A bank that has crossed the 10 percent threshold with one affiliate may still conduct additional covered transactions with other affiliates, if transactions with all affiliates would not exceed 20 percent of the bank's capital stock and surplus.<sup>3</sup> The bank is prohibited from engaging in a new covered transaction with that affiliate if the bank's transactions would exceed the 10 percent threshold with that affiliate or if the level of covered transactions with all its affiliates would exceed the 20 percent threshold. The rule generally does not require the member bank to unwind existing covered transactions if the bank exceeds the 10 percent or 20 percent limit because its capital declined or a preexisting covered transaction increased in value.

The Board strongly encourages member banks with covered transactions in excess of the 10 percent threshold with any affiliate to reduce those transactions before expanding the scope or extent of the bank's relationships with other affiliates. Section 223.11 of the rule also clarifies that transactions between a bank and a financial subsidiary of the bank are not subject to the 10 percent limit of section 23A but instead are subject to the 20 percent limitation.

### Capital Stock and Surplus

Under section 23A of the FRA, the quantitative limits on covered transactions are based on the "capital stock and surplus" of the member bank. Section 223.3(d) of the rule defines a member bank's capital stock and surplus, for the purposes of section 23A of the FRA, as (1) the sum of the member bank's tier 1 capital and tier 2 capital under the risk-based capital guidelines,

1. In this section of the manual, Regulation W is referred to as "the rule" or by a specific section number of the rule.

2. Member bank is defined in section 223.3(w) as "any national bank, state bank, banking association, or trust company that is a member of the Federal Reserve System." Other provisions of federal law apply section 23A to state nonmember banks and savings associations. The rule also states that most subsidiaries of a member bank are to be treated as part of the member bank itself for purposes of sections 23A and 23B. The only subsidiaries of a member bank that are excluded from this treatment are financial subsidiaries, insured

depository institution subsidiaries, and certain joint venture subsidiaries—companies that are generally deemed affiliates of the member bank under the rule. This treatment of subsidiaries reflects the fact that the statute typically does not distinguish between a member bank and its subsidiaries, and all the significant restrictions of the statute apply to actions taken by a member bank "and its subsidiaries."

3. See 12 USC 371c(a)(1). Sections 223.11 and 223.12 of the rule set forth these quantitative limits.

(2) the balance of the bank's allowance for loan and lease losses not included in its tier 2 capital for the purposes of the risk-based capital calculation, and (3) the amount of any investment in a financial subsidiary that counts as a covered transaction that is required to be deducted from the bank's regulatory capital.<sup>4</sup>

Examiners can determine the amount of the quantitative limits based on the bank's most recent Consolidated Report of Condition and Income (Call Report).

## Affiliates

The definition of an affiliate is found in section 23A of the FRA. Section 223.2 of Regulation W further defines "affiliate" as including

1. any company that controls<sup>5</sup> the member bank and any other company that is controlled by the company that controls the member bank;
2. any bank subsidiary of the member bank;
3. any company—
  - that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the member bank or any company that controls the member bank; or
  - in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the member bank or any company that controls the member bank;
4. any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the member bank or any subsidiary or affiliate of the member bank;
5. any investment company with respect to which a member bank or any affiliate thereof is an investment adviser as defined in section 2(a)(20) of the Investment Company Act of 1940 (the 1940 Act);
6. any investment fund for which the member bank or any affiliate of the member bank

serves as an investment adviser, if the member bank and its affiliates own or control in the aggregate more than 5 percent of any class of voting securities or of the equity capital of the fund;

7. a depository institution that is a subsidiary of the member bank;
8. a financial subsidiary of the member bank;
9. any company in which a holding company of the member bank owns or controls, directly or indirectly, or acting through one or more other persons, 15 percent or more of the equity capital of the other company<sup>6</sup> pursuant to the merchant banking authority in section 4(k)(4)(H) or (I) of the Bank Holding Company Act (BHC Act) (12 USC 1843(k)(4)(H) or (I));
10. any partnership for which the member bank or any affiliate of the member bank serves as a general partner or for which the member bank or any affiliate of the member bank causes any director, officer, or employee of the member bank or affiliate to serve as a general partner;
11. any subsidiary of an affiliate described in paragraphs (a)(1) through (10) of section 223.2 of Regulation W; and
12. any company that the Board, or the appropriate federal banking agency for the bank, determines by regulation or order to have a relationship with the member bank or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with that company may be affected by the relationship, to the detriment of the member bank or its subsidiary.

The following are not considered to be affiliates of a bank:

1. a nonbank subsidiary of that bank (other than a financial subsidiary) unless the Board determines not to exclude such a subsidiary;
2. a company engaged solely in holding that bank's premises;
3. a company engaged solely in conducting a safe deposit business;
4. a company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United

4. 12 CFR 223.3(d).

5. By statute, "control" is defined as the power to (1) vote 25 percent or more of the voting shares of a company, (2) elect a majority of the directors of a company, or (3) exercise a controlling influence over a company.

6. The financial holding company may provide information acceptable to the Board demonstrating that it does not control the other company.

- States or its agencies as to principal and interest; and
5. a company in which control arises from the exercise of rights arising out of a bona fide debt previously contracted (for the period of time specified by section 23A).

### *Definition of Affiliates by Type of Entity*

*Investment funds advised by the member bank or an affiliate of the member bank.* Section 23A includes as an affiliate any company that is sponsored and advised on a contractual basis by the member bank or any of its affiliates,<sup>7</sup> as well as any investment company for which the member bank or its affiliate serves as an investment adviser, as defined in the 1940 Act.<sup>8</sup> In Regulation W, the Board used its statutory authority to define as an affiliate any investment fund—even if not an investment company for purposes of the 1940 Act—for which the member bank or an affiliate of the bank serves as an investment adviser, if the bank or an affiliate of the bank owns or controls more than 5 percent of any class of voting securities or similar interests of the fund.

Many investment funds that are advised by a member bank (or an affiliate of a member bank) are affiliates of the bank under section 23A because the funds either are investment companies under the 1940 Act or are sponsored by the member bank (or an affiliate of the member bank). The member bank or its affiliate, in some instances, however, may advise but not sponsor an investment fund that is not an investment company under the 1940 Act.<sup>9</sup> The advisory relationship of a member bank or affiliate with an investment fund presents the same potential for conflicts of interest regardless of whether the fund is an investment company under the 1940 Act.<sup>10</sup> Section 223.2(a)(6) treats any investment

fund as an affiliate if the bank or an affiliate of the bank serves as an investment adviser to the fund and owns more than 5 percent of the shares of the fund.

*Financial Subsidiaries.* In 1999, the Gramm-Leach-Bliley Act (the GLB Act) authorized banks to own “financial subsidiaries” that engage in activities not permissible for the parent bank to conduct directly, such as underwriting and dealing in bank-ineligible securities. The GLB Act amended section 23A to define a financial subsidiary of a bank as an affiliate of the bank and thus subjected covered transactions between the bank and a financial subsidiary to the limitations of sections 23A and 23B.

Section 23A defines a financial subsidiary as a subsidiary of any bank (state or national) that is engaged in an activity that is not permissible for national banks to engage in directly other than a subsidiary that federal law specifically authorizes national banks to own or control. Specifically, a “financial subsidiary” is defined as “any company that is a subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States.”<sup>11</sup> Section 5136A, in turn, defines a financial subsidiary as any company that is controlled by one or more insured depository institutions (IDIs), other than (1) a subsidiary that engages solely in activities that national banks are permitted to engage in directly or (2) a subsidiary that national banks are specifically authorized to control by the express terms of a federal statute (other than section 5136A), such as an Edge Act corporation or a small business investment company (SBIC).<sup>12</sup> (See 12 USC 24a(g)(3).) Section 5136A also generally prohibits a financial subsidiary of a national bank from engaging in insurance underwriting, real estate investment and development, or merchant banking activities.<sup>13</sup> (See 12 USC 24a(a)(2)). Regulation W (1) defines a financial subsidiary of a bank, (2) exempts certain companies from the definition, and (3) sets forth special valuation and other rules for financial subsidiaries. (See sections 223.2(a)(8), 223.3(p), and 223.32 of the rule.)

*Partnerships.* Banks fund legitimate commercial transactions through partnerships. Partner-

7. 12 USC 371c(b)(1)(D)(i).

8. 12 USC 371c(b)(1)(D)(ii).

9. 12 USC 371c(b)(1)(E).

10. An investment fund typically escapes from the definition of investment company under the 1940 Act because it (1) sells interests only to a limited number of investors or only to sophisticated investors or (2) invests primarily in financial instruments that are not securities. A member bank may face greater risk from the conflicts of interest arising from its relationships with an investment fund that is not registered than an investment company under the 1940 Act because the 1940 Act restricts transactions between a registered investment company and entities affiliated with the company's investment adviser. (See 15 USC 80a-17.)

11. 12 USC 24a(g)(3). (See also 12 USC 371c(e)(1)).

12. 12 USC 24a(a)(2).

13. 12 USC 371c(e)(1).

ships for which a member bank or an affiliate serves as a general partner are affiliates.

Regulation W also defines an affiliate of a member bank as any partnership, if the member bank or an affiliate of the bank causes any director, officer, or employee of the bank or affiliate to serve as a general partner of the partnership (unless the partnership is an operating subsidiary of the bank). Also, if a company, such as a bank holding company (BHC), controls more than 25 percent of the equity through a partnership, that company is an affiliate under Regulation W.

*Subsidiaries of affiliates.* Regulation W deems a subsidiary of an affiliate as an affiliate of the member bank.

## Companies Designated by the Appropriate Federal Banking Agency

Under section 223.2(a)(12), the Board can determine that any company that has certain relationships with a member bank or an affiliate of the bank is itself an affiliate of the bank such that covered transactions by the bank with that company may be affected by the relationship to the detriment of the bank. The Board and the federal banking agencies can thus protect the member bank in their transactions with associated companies. A member bank may petition the Board for review of any such affiliate determination made by the institution's appropriate federal banking agency under the general procedures established by the Board for review of actions taken under delegated authority.<sup>14</sup>

## Companies That Are not Affiliates

*Joint venture companies.* Under section 223.2(b)(1)(iii) of the rule, certain joint venture subsidiary companies of a member bank are treated as affiliates. A subsidiary of a member bank is treated as an affiliate if one or more affiliates of the bank, or one or more controlling shareholders of the bank, directly control the joint venture. For example, if a bank controls 30 percent of Company A and an affiliate controls 70 percent of Company A, then Company A is an affiliate. This expansion also

covers situations in which a controlling natural-person shareholder or group of controlling natural-person shareholders of the member bank (who, as natural persons, are not themselves section 23A affiliates of the bank) exercise direct control over the joint venture company.

The rule's treatment of certain bank-affiliate joint ventures as affiliates does not apply to joint ventures between a member bank and any affiliated IDIs. For example, if two affiliated member banks each own 50 percent of the voting common shares of a company, the company would continue to qualify as a subsidiary and not an affiliate of each bank (despite the fact that an affiliate of each bank owned more than 25 percent of a class of voting securities of the company). The Board has retained its authority to treat such joint ventures as affiliates under section 23A on a case-by-case basis.

*Employee benefit plans.* Regulation W clarifies that under section 223.2(b)(1)(iv), an employee stock option plan (ESOP) of a member bank or an affiliate of the bank cannot itself avoid classification as an affiliate of the bank by also qualifying as a subsidiary of the bank. Many, but not all, ESOPs, trusts, or similar entities that exist to benefit shareholders, members, officers, directors, or employees of a member bank or its affiliates are treated as affiliates of the bank for purposes of sections 23A and 23B. The ESOP's share ownership or the interlocking management between the ESOP and its associated member bank (or BHC), in many cases, exceeds the statutory thresholds for determining that a company is an affiliate. For example, if an ESOP controls more than 25 percent of the voting shares of the bank or BHC, the ESOP is an affiliate.

The relationship between a member bank and its (or its) affiliate's ESOP generally warrants coverage by sections 23A and 23B. Member banks have made unsecured loans to their ESOPs or their affiliates or have guaranteed loans to such ESOPs that were made by a third party. These ESOPs, however, generally have no means to repay the loans other than with funds provided by the member bank. In addition, even if the ESOP's ownership does not warrant treatment as an affiliate, the issuance of holding company shares to an ESOP that is funded by a loan from the holding company's subsidiary bank could be used as a vehicle by the bank to provide funds to its parent company when the bank is unable to pay dividends or is otherwise

14. See 12 CFR 265.3.

restricted in providing funds to its holding company. The attribution rule (12 CFR 223.16) subjects such transactions to the restrictions of sections 23A and 23B.

## Determination of Control

Section 23A provides that a company or shareholder shall be deemed to have control over another company if, among other things, such company or shareholder controls in any manner the election of a majority of the “directors or trustees” of the other company.<sup>15</sup> The rule, under section 223.3(g), expands the control definition of section 23A by providing, as in Regulation Y, that control also exists when a company or shareholder controls the election of a majority of the “general partners (or individuals exercising similar functions)” of another company. A company or shareholder would be deemed to control another company (including a partnership, limited-liability company, or other similar organization) under section 23A if the company or shareholder controls the election of a majority of the principal policymakers of such other company.

Under Regulation W, the definition of “control” is similar, but not identical, to the definition used in the BHC Act. Under the rule, a company or shareholder shall be deemed to have control over another company if—

- such company or shareholder, directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company;
- such company or shareholder controls in any manner the election of a majority of the directors or trustees or general partners or individuals exercising similar functions of the other company; or
- the Board determines, after notice and opportunity for hearing, that such company or shareholder, directly or indirectly, exercises a controlling influence over the management or policies of the other company.<sup>16</sup>

In addition, under the rule, three additional presumptions of control are provided, similar to the presumptions of control in Regulation Y.

15. 12 USC 371c(b)(3)(A)(ii).

16. See 12 CFR 223.3(g) of the rule.

First, a company will be deemed to control securities, assets, or other ownership interests controlled by any subsidiary of the company.<sup>17</sup> Second, a company that controls instruments (including options and warrants) that are convertible or exercisable, at the option of the holder or owner, into securities, will be deemed to control the securities.<sup>18</sup> Third, a rebuttable presumption provides that a company or shareholder that owns or controls 25 percent or more of the equity capital of another company controls the other company, unless the company or shareholder demonstrates otherwise to the Board based on the facts and circumstances of the particular case.<sup>19</sup> (See section 223.3(g).) Such a presumption of control is particularly appropriate in the section 23A context because a BHC may have incentives to divest the resources of a subsidiary bank to any company in which the holding company has a substantial financial interest, regardless of whether the holding company owns any voting securities of the company.

Section 23A and Regulation W provide that no company shall be deemed to own or control another company by virtue of its ownership or control of shares in a fiduciary capacity, except (1) a company that is controlled, directly or indirectly, by a trust for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, a member bank or (2) if the company owning or controlling such shares is a business trust.

## Covered Transactions

The restrictions of section 23A do not apply to every transaction between a member bank and its affiliates.<sup>20</sup> The section only applies to five “covered transactions” between a member bank and its affiliates.<sup>21</sup>

17. See 12 CFR 225.2(e)(2)(i).

18. See 12 CFR 225.31(d)(1)(i). The rule refers more generically to convertible “instruments.” It clarifies that the convertibility presumption applies regardless of whether the right to convert resides in a financial instrument that technically qualifies as a “security” under section 23A or the federal securities laws.

19. See, for example, 12 CFR 225.144 and 225.145 (1982 and 2008 Board Policy Statements on Nonvoting Equity Investments).

20. 12 USC 371c(b)(7).

21. The investment by a member bank or its affiliate in a financial subsidiary of the bank excludes the retained earnings of the financial subsidiary.

A covered transaction under section 23A means

1. a loan or extension of credit to an affiliate;
2. a purchase of or an investment in securities issued by an affiliate;
3. a member bank's purchase of assets from an affiliate, including assets subject to recourse or an agreement to repurchase, except for purchases of real and personal property as may be specifically exempted by the Board by order or regulation;
4. the acceptance of securities issued by an affiliate as collateral for a loan to any person or company;<sup>22</sup> or
5. the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.

If a transaction between a member bank and an affiliate is not within one of the above categories, it is not a covered transaction for the purposes of section 23A and is not subject to its limitations. All covered transactions must be conducted on terms and conditions that are consistent with safe and sound banking practices.<sup>23</sup>

Among the transactions that generally are not subject to section 23A are dividends paid by a member bank to its holding company, sales of assets by a member bank to an affiliate for cash, an affiliate's purchase of securities issued by a member bank, and many service contracts between a member bank and an affiliate. Certain classes of transactions between a member bank and an affiliate are discussed below as to whether they are covered transactions for purposes of section 23A. (See section 223.3(h).)

## Attribution Rule

The "attribution rule," found in section 223.16, prevents a member bank from evading the restrictions of section 23A of the FRA by using intermediaries, and it limits the exposure that a member bank has to customers of affiliates of

the bank. Any covered transaction by a member bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate. For example, a member bank's loan to a customer for the purpose of purchasing securities from the inventory of a broker-dealer affiliate of the bank would be a covered transaction under section 23A.

## Credit Transactions with an Affiliate

### *Extension of Credit to an Affiliate or Other Credit Transaction with an Affiliate*

Section 23A includes a "loan or extension of credit" to an affiliate as a covered transaction but does not define these terms. Section 223.3(o) of the rule defines "extension of credit" to an affiliate to mean the making or renewal of a loan to an affiliate, the granting of a line of credit to an affiliate, or the extending of credit to an affiliate in any manner whatsoever, including on an intraday basis. A list of transactions are defined to be extensions of credit in the rule, but are not limited to the following transactions:

1. an advance to an affiliate by means of an overdraft, cash item, or otherwise
2. a sale of federal funds to an affiliate
3. a lease that is the functional equivalent of an extension of credit to an affiliate
4. an acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or other debt securities, of an affiliate<sup>24</sup>
5. any increase in the amount of, extension of the maturity of, or adjustment to the interest-rate term or other material term of, an extension of credit to an affiliate<sup>25</sup>
6. any other similar transaction as a result of

<sup>24</sup> The Board would consider a full-payout net lease permissible for a national bank under 12 USC 24 (seventh) and 12 CFR 23 to be the functional equivalent of an extension of credit.

<sup>25</sup> A floating-rate loan does not become a new covered transaction whenever there is a change in the relevant index (for example, LIBOR or the member bank's prime rate) from which the loan's interest rate is calculated. If the member bank and the borrower, however, amend the loan agreement to change the interest-rate term from "LIBOR plus 100 basis points" to "LIBOR plus 150 basis points," the parties have engaged in a new covered transaction.

<sup>22</sup> The acceptance of an affiliate's securities for a loan where the proceeds are transferred to, or used for the benefit of, an affiliate is prohibited. See the rule, section 223.3(h)(2).

<sup>23</sup> Board staff has taken the position that safety and soundness requires the transaction be conducted on market terms.

which an affiliate becomes obligated to pay money (or its equivalent) to a member bank<sup>26</sup>

A member bank's purchase of a debt security issued by an affiliate is an extension of credit by the bank to the affiliate for purposes of section 23A under the rule. A member bank that buys debt securities issued by an affiliate has made an extension of credit to an affiliate under section 23A and must collateralize the transaction in accordance with the collateral requirements of section 23A. An exemption from the collateral requirements is provided for situations in which a member bank purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction.

## Issuance of a Guarantee or Letter of Credit

### *Confirmation of a Letter of Credit Issued by an Affiliate.*

Section 23A includes as a covered transaction the issuance by a member bank of a letter of credit on behalf of an affiliate, including the confirmation of a letter of credit issued by an affiliate as a covered transaction. See section 223.3(h)(5).<sup>27</sup> When a bank confirms a letter of credit, it assumes the risk of the underlying transaction to the same extent as if it had issued the letter of credit. Accordingly, a confirmation of a letter of credit issued by an affiliate is treated in the same fashion as an issuance of a letter of credit on behalf of an affiliate.

### *Credit Enhancements Supporting a Securities Underwriting*

The definition of guarantee in section 23A does not include a member bank's issuance of a guarantee in support of securities issued by a third party and underwritten by a securities affiliate of the bank.<sup>28</sup> Such a credit enhancement would not be issued "on behalf of" the affiliate. Although the guarantee does provide

some benefit to the affiliate (by facilitating the underwriting), this benefit is indirect. The proceeds of the guarantee would not be transferred to the affiliate for purposes of the attribution rule of section 23A.<sup>29</sup> Section 23B would apply to the transaction and, where an affiliate was issuer as well as underwriter, the transaction would be covered by section 23A because the credit enhancement would be on behalf of the affiliate.

### *Cross-Guarantee Agreements and Cross-Affiliate Netting Arrangements*

A cross-guarantee agreement among a member bank, an affiliate, and a nonaffiliate in which the nonaffiliate may use the bank's assets to satisfy the obligations of a defaulting affiliate is a guarantee for purposes of section 23A. The cross-guarantee arrangements among member banks and their affiliates are subject to the quantitative limits and collateral requirements of section 23A. (See section 223.3(h)(5).)

As for cross-affiliate netting arrangements (CANAs), such arrangements involve a member bank, one or more affiliates of the bank, and one or more nonaffiliates of the bank, where a nonaffiliate is permitted to deduct obligations of an affiliate of the bank to the nonaffiliate when settling the nonaffiliate's obligations to the bank. These arrangements also would include agreements in which a member bank is required or permitted to add the obligations of an affiliate of the bank to a nonaffiliate when determining the bank's obligations to the nonaffiliate.

These types of CANAs expose a member bank to the credit risk of its affiliates because the bank may become liable for the obligations of its affiliates. Because the exposure of a member bank to an affiliate in such an arrangement resembles closely the exposure of a member bank when it issues a guarantee on behalf of an affiliate, the rule explicitly includes such arrangements in the definition of covered transaction. Accordingly, the quantitative limits of section 23A would prohibit a member bank from entering into such a CANA to the extent that the netting arrangement does not cap the potential exposure of the bank to the participating affiliate (or affiliates).

26. The definition of extension of credit would cover, among other things, situations in which an affiliate fails to pay on a timely basis for services rendered to the affiliate by the member bank or fails to pay a tax refund to the member bank.

27. See UCC 5-107(2).

28. See 62 Fed. Reg. 45295 (August 27, 1997).

29. See 12 USC 371c(a)(2).



## Keepwell Agreements

In a keepwell agreement between a member bank and an affiliate, the bank typically commits to maintain the capital levels or solvency of the affiliate. The credit risk incurred by the member bank in entering into such a keepwell agreement is similar to the credit risk incurred by a member bank in connection with issuing a guarantee on behalf of an affiliate. As a consequence, keepwell agreements generally should be treated as guarantees for purposes of section 23A and, if unlimited in amount, would be prohibited by the quantitative limits of section 23A.

## Prohibition on the Purchase of Low-Quality Assets

Section 23A generally prohibits the purchase by a member bank of a low-quality asset from an affiliate.<sup>30</sup> In addition, a member bank cannot purchase or accept as collateral a low-quality asset from an affiliate. Section 23A defines a low-quality asset to include (1) an asset classified as “substandard,” “doubtful,” or “loss,” or treated as “other loans specially mentioned,” in the most recent report of examination or inspection by a federal or state supervisory agency (a “classified asset”); (2) an asset in nonaccrual status; (3) an asset on which payments are more than 30 days past due; or (4) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.<sup>31</sup> Any asset meeting one of the above four criteria, including securities and real property, is a low-quality asset.<sup>32</sup>

Regulation W expands the definition of low-quality assets in several respects. (See 12 CFR 223.3(v).) First, an asset is identified by examiners as a low-quality asset if they represent credits to countries that are not complying with

their external debt-service obligations but are taking positive steps to restore debt service through economic adjustment measures, generally as part of an International Monetary Fund program. Although such assets may not be considered classified assets, examiners are to consider these assets in their assessment of a bank’s asset quality and capital adequacy. See also section 7040.3 and SR-08-12.

Second, the rule considers a financial institution’s use of its own internal asset-classification systems. The rule includes within the definition of low-quality asset not only assets classified during the last examination but also assets classified or treated as special mention under the institution’s internal classification system (or assets that received an internal rating that is substantially equivalent to classified or special mention in such an internal system).

The purchase by a depository institution from an affiliate of assets that have been internally classified raises potentially significant safety-and-soundness concerns. The Board expects companies with internal rating systems to use the systems consistently over time and over similar classes of assets and will view as an evasion of section 23A any company’s deferral or alteration of an asset’s rating to facilitate sale of the asset to an affiliated institution.

Finally, the rule defines low-quality asset to include foreclosed property designated “other real estate owned” (OREO), until it is reviewed by an examiner and receives a favorable rating. It further defines as a low-quality asset any asset (not just real estate) that is acquired in satisfaction of a debt previously contracted (not just through foreclosure) if the asset has not yet been reviewed in an examination or inspection. Under the rule, if a particular asset is good collateral taken from a bad borrower, the asset should cease to be a low-quality asset upon examination.

Section 23A provides a limited exception to the general rule prohibiting purchase of low-quality assets if the bank performs an independent credit evaluation and commits to the purchase of the asset before the affiliate acquires the asset.<sup>33</sup> Section 223.15 of the rule also provides an exception from the prohibition on the purchase by a member bank of a low-quality asset from an affiliate for certain loan renewals. The rule allows a member bank that purchased a loan participation from an affiliate to renew its par-

30. 12 USC 371c(a)(3). Section 23A does not prohibit an affiliate from donating a low-quality asset to a member bank, so long as the bank provides no consideration for the asset, and no liabilities are associated with the asset.

31. 12 USC 371c(b)(10).

32. The federal banking agencies generally consider non-investment-grade securities to be classified assets. See, for example, the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks (May 7, 1979) and also table 3 in section 2020.1 of this manual. Assets identified by examiners through the Shared National Credit and Interagency Country Exposure Review Committee processes also should be considered classified assets for purposes of section 23A.

33. 12 USC 371c(a)(3).

ticipation in the loan, or provide additional funding under the existing participation, even if the underlying loan had become a low-quality asset, so long as certain criteria were met. These renewals or additional credit extensions may enable both the affiliate and the participating member bank to avoid or minimize potential losses. The exception is available only if (1) the underlying loan was not a low-quality asset at the time the member bank purchased its participation and (2) the proposed transaction would not increase the member bank's proportional share of the credit facility. The member bank must also obtain the prior approval of its entire board of directors (or its delegees) and it must give a 20-days' post-consummation notice to its appropriate federal banking agency. A member bank is permitted to increase its proportionate share in a restructured loan by 5 percent (or by a higher percentage with the prior approval of the bank's appropriate federal banking agency). The scope of the exemption includes renewals of participations in loans originated by any affiliate of the member bank (not just affiliated depository institutions).

## Valuation of Credit Transactions with an Affiliate

A credit transaction between a member bank and an affiliate initially must be valued at the amount of funds provided by the member bank to, or on behalf of, the affiliate plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate. The section 23A value of a credit transaction between a member bank and an affiliate is the greater of (1) the principal amount of the credit transaction; (2) the amount owed by the affiliate to the member bank under the credit transaction; or (3) the sum of (a) the amount provided to, or on behalf of, the affiliate in the transaction and (b) any additional amount that the member bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction.

The first prong of the rule's valuation formula for credit transactions ("the principal amount of the credit transaction") would likely determine the valuation of a transaction in which a member bank purchased a zero-coupon note issued by an affiliate. A member bank should value such an extension of credit at the principal, or face,

amount of the note (that is, at the amount that the affiliate ultimately must pay to the bank) rather than at the amount of funds initially advanced by the bank. For example, assume a member bank purchased from an affiliate for \$50 a 10-year zero-coupon note issued by the affiliate with a face amount of \$100. The rule's valuation formula requires the member bank to value this transaction at \$100.

The second prong of the rule's valuation formula for credit transactions ("the amount owed by the affiliate") likely would determine the valuation of a transaction in which an affiliate fails to pay a member bank when due a fee for services rendered by the bank to the affiliate. This prong of the valuation formula does not include within section 23A's quantitative limits items such as accrued interest not yet due on a member bank's loan to an affiliate.

Member banks will be able to determine the section 23A value for most credit transactions under the third prong of the rule's valuation formula. Under this prong, for example, a \$100 term loan is a \$100 covered transaction, a \$300 revolving credit facility is a \$300 covered transaction (regardless of how much of the facility the affiliate has drawn down), and a guarantee backstopping a \$500 debt issuance of the affiliate is a \$500 covered transaction.

Under section 23A and the rule, a member bank has made an extension of credit to an affiliate if the bank purchases from a third party a loan previously made to an affiliate of the bank. A different valuation formula is provided for these indirect credit transactions. The member bank must value the transaction at the price paid by the bank for the loan plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate under the terms of the credit agreement.

For example, if a member bank pays a third party \$90 for a \$100 term loan that the third party previously made to an affiliate of the bank (because, for example, the loan was at a fixed rate and has declined in value because of a rise in the general level of interest rates), the covered transaction amount is \$90 rather than \$100. The lower covered-transaction amount reflects the fact that the member bank's maximum loss on the transaction is \$90 rather than the original principal amount of the loan. For another example, if a member bank pays a third party \$70 for a \$100 line of credit to an affiliate, of which \$70 had been drawn down by the affiliate, the covered-transaction amount would be \$100 (the

\$70 purchase price paid by the bank for the credit plus the remaining \$30 that the bank could be required to lend under the credit line).

In another example, a member bank makes a term loan to an affiliate that has a principal amount of \$100. The affiliate pays \$2 in up-front fees to the member bank, and the affiliate receives net loan proceeds of \$98. The member bank must initially value the covered transaction at \$100.

Although the rule considers a member bank's purchase of, or investment in, a debt security issued by an affiliate as an extension of credit to an affiliate, these transactions are not valued like other extensions of credit. See section 223.23 for the valuation rules for purchases of, and investments in, the debt securities of an affiliate.

### Timing of a Credit Transaction with an Affiliate

A member bank has entered into a credit transaction with an affiliate at the time during the day that the bank becomes legally obligated to make the extension of credit to, or issue the guarantee, acceptance, or letter of credit on behalf of, the affiliate. A covered transaction occurs at the moment that the member bank executes a legally valid, binding, and enforceable credit agreement or guarantee and does not occur only when a member bank funds a credit facility or makes payment on a guarantee. Consistent with section 23A, the rule only requires a member bank to compute compliance with its quantitative limits when the bank is about to engage in a new covered transaction. The rule does not require a member bank to compute compliance with the rule's quantitative limits on a continuous basis. See section 223.21(b)(1) of the rule.

The burden of the timing rule is significantly mitigated by the exemption for intraday extensions of credit found in section 223.42(l). The intraday credit exemption generally applies only to extensions of credit that a member bank expects to be repaid, sold, or terminated by the end of its U.S. business day. The bank must have policies and procedures to manage and minimize the credit exposure. Any such extension of credit that is outstanding at the end of the bank's business day must be treated as an extension of credit and must meet the regulatory quantitative and collateral requirements.

### Asset Purchases from an Affiliate

Regulation W provides that a purchase of assets by a member bank from an affiliate initially must be valued at the total amount of consideration given by the bank in exchange for the asset. (See section 223.22.) This consideration can take any form and includes an assumption of liabilities by the member bank. Asset purchases are a covered transaction for a member bank for as long as the bank holds the asset. The value of the covered transaction after the purchase may be reduced to reflect amortization or depreciation of the asset, to the extent that such reductions are consistent with generally accepted accounting principles (GAAP) and are reflected on the bank's financial statements.

Certain asset purchases by a member bank from an affiliate are not valued in accordance with the general asset-purchase valuation formula. First, if the member bank buys from one affiliate a loan to a second affiliate, the bank must value the transaction as a credit transaction with the second affiliate under section 223.21. Second, if the member bank buys from one affiliate a security issued by a second affiliate, the bank must value the transaction as an investment in securities issued by the second affiliate under section 223.23. Third, if the member bank acquires an affiliate that becomes an operating subsidiary of the bank after the acquisition, the bank must value the transaction under section 223.31.

A special valuation rule applies to a member bank's purchase of a line of credit or loan commitment from an affiliate. A member bank initially must value such asset purchases at the purchase price paid by the bank for the asset plus any additional amounts that the bank is obligated to provide under the credit facility.<sup>34</sup> This special valuation rule ensures that there are limits on the amount of risk a company can shift to an affiliated bank.

Section 23A(d)(6) provides an exemption for purchasing assets having a readily identifiable and publically available market quotation. Section 223.42(e) codifies this exemption. Section 223.42(f) of the rule expands the statutory (d)(6)

<sup>34</sup> A member bank would not be required to include unfunded, but committed, amounts in the value of the covered transaction if (1) the credit facility being transferred from the affiliate to the bank is unconditionally cancelable (without cause) at any time by the bank and (2) the bank makes a separate credit decision before each drawing under the facility.

exemption<sup>35</sup> to allow a member bank to purchase securities from an affiliate based on price quotes obtained from certain electronic services so long as, among other things, (1) the selling affiliate is a broker-dealer registered with the Securities and Exchange Commission (SEC), (2) the securities have a ready market and are eligible for purchase by state member banks, (3) the securities are not purchased within 30 days of an underwriting (if an affiliate of the bank is an underwriter of the securities), and (4) the securities are not issued by an affiliate.

In contrast with credit transactions, an asset purchase from a nonaffiliate that later becomes an affiliate generally does not become a covered transaction for the purchasing member bank. If a member bank purchases assets from a nonaffiliate in contemplation of the nonaffiliate's becoming an affiliate of the bank, however, the asset purchase becomes a covered transaction at the time the nonaffiliate becomes an affiliate. In addition, the member bank must ensure that the aggregate amount of the bank's covered transactions (including any such asset purchase from the nonaffiliate) would not exceed the quantitative limits of section 23A at the time the nonaffiliate becomes an affiliate.

The following examples are provided to assist member banks in valuing purchases of assets from an affiliate. A member bank's receipt of an encumbered asset from an affiliate ceases to be a covered transaction when, for example, the bank sells the asset.

- *Cash purchase of assets.* A member bank purchases a pool of loans from an affiliate for \$10 million. The member bank initially must value the covered transaction at \$10 million. Going forward, if the borrowers repay \$6 million of the principal amount of the loans, the member bank may value the covered transaction at \$4 million.
- *Purchase of assets through an assumption of liabilities.* An affiliate of a member bank contributes real property with a fair market value of \$200,000 to the member bank. The member bank pays the affiliate no cash for the property, but assumes a \$50,000 mortgage on the property. The member bank has engaged in a covered transaction with the affiliate and initially must value the transaction at \$50,000. Going forward, if the member bank retains the real property but pays off the mortgage, the

member bank must continue to value the covered transaction at \$50,000. If the member bank, however, sells the real property, the transaction ceases to be a covered transaction at the time of the sale (regardless of the status of the mortgage).

### Purchase of, and Investment in, Securities Issued by an Affiliate

Section 23A includes as a covered transaction a member bank's purchase of, or investment in, securities issued by an affiliate. Section 223.23 of the rule requires a member bank to value a purchase of, or investment in, securities issued by an affiliate (other than a financial subsidiary of the bank) at the greater of the bank's purchase price or carrying value of the securities.<sup>36</sup> A member bank that paid no consideration in exchange for affiliate securities has to value the covered transaction at no less than the bank's carrying value of the securities. In addition, if the member bank's carrying value of the affiliate securities increased or decreased after the bank's initial investment (due to profits or losses at the affiliate), the amount of the bank's covered transaction would increase or decrease to reflect the bank's changing financial exposure to the affiliate. However, the amount of the bank's covered transaction cannot decline below the amount paid by the bank for the securities.

Several important considerations support the general carrying-value approach of this valuation rule. First, the approach is consistent with GAAP, which would require a bank to reflect its investment in securities issued by an affiliate at carrying value throughout the life of the investment, even if the bank paid no consideration for the securities.

Second, the approach is supported by the terms of the statute, which defines both a "purchase of," and an "investment in," securities issued by an affiliate as a covered transaction. The statute's "investment in" language indicates that Congress was concerned with a member bank's continuing exposure to an affiliate through an ongoing investment in the affiliate's securities.

Third, GLB Act amendments to section 23A support the approach. The GLB Act defines a

<sup>36</sup> Carrying value refers to the amount at which the securities are carried on the GAAP financial statements of the member bank.

35. 12 USC 371c(d)(6).

financial subsidiary of a bank as an affiliate of the bank but specifically provides that the section 23A value of a bank's investment in securities issued by a financial subsidiary does not include retained earnings of the subsidiary. The negative implication from this provision is that the section 23A value of a bank's investment in other affiliates includes the affiliates' retained earnings, which would be reflected in the bank's carrying value of the investment under the rule.

Finally, the carrying-value approach is consistent with the purposes of section 23A—limiting the financial exposure of banks to their affiliates and promoting safety and soundness. The valuation rule requires a member bank to revalue upwards the amount of an investment in affiliate securities only when the bank's exposure to the affiliate increases (as reflected on the bank's financial statements) and the bank's capital increases to reflect the higher value of the investment. In these circumstances, the valuation rule merely reflects the member bank's greater financial exposure to the affiliate and enhances safety and soundness by reducing the bank's ability to engage in additional transactions with an affiliate as the bank's exposure to that affiliate increases.

The valuation rule also provides that the covered-transaction amount of a member bank's investment in affiliate securities can be no less than the purchase price paid by the bank for the securities, even if the carrying value of the securities declines below the purchase price. Although this aspect of the valuation rule is not consistent with GAAP, using the member bank's purchase price for the securities as a floor for valuing the covered transaction is appropriate. First, it ensures that the amount of the covered transaction never falls below the amount of funds actually transferred by the member bank to the affiliate in connection with the investment. In addition, the purchase-price floor limits the ability of a member bank to provide additional funding to an affiliate as the affiliate approaches insolvency. If investments in securities issued by an affiliate were valued strictly at carrying value, then the member bank could lend more funds to the affiliate as the affiliate's financial condition worsened. As the affiliate declined, the member bank's carrying value of the affiliate's securities would decline, the section 23A value of the bank's investment likely would decline, and, consequently, the bank would be able to provide additional funding to the affiliate under

section 23A. This type of increasing support for an affiliate in distress is what section 23A was intended to restrict.

The examples provided below are designed to assist member banks in valuing purchases of, and investments in, securities issued by an affiliate.

- *Purchase of the debt securities of an affiliate.* The parent holding company of a member bank owns 100 percent of the shares of a mortgage company. The member bank purchases debt securities issued by the mortgage company for \$600. The initial carrying value of the securities is \$600. The member bank initially must value the investment at \$600.
- *Purchase of the shares of an affiliate.* The parent holding company of a member bank owns 51 percent of the shares of a mortgage company. The member bank purchases an additional 30 percent of the shares of the mortgage company from a third party for \$100. The initial carrying value of the shares is \$100. The member bank initially must value the investment at \$100. Going forward, if the member bank's carrying value of the shares declines to \$40, the member bank must continue to value the investment at \$100.
- *Contribution of the shares of an affiliate.* The parent holding company of a member bank owns 100 percent of the shares of a mortgage company and contributes 30 percent of the shares to the member bank. The member bank gives no consideration in exchange for the shares. If the initial carrying value of the shares is \$300, then the member bank initially must value the investment at \$300. Going forward, if the member bank's carrying value of the shares increases to \$500, the member bank must value the investment at \$500.

## Extensions of Credit Secured by Affiliates' Securities

### *Extensions of Credit—General Valuation Rule (Section 223.24(a) and (b))*

Section 23A defines as a covered transaction a member bank's acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any person or company. This type of covered transaction has two classes: one in which the only collateral for the loan is solely affiliate securities and another in which the loan

is secured by a combination of affiliate securities and other collateral.

### *Extensions of Credit Secured by Mutual Fund Shares*

Section 23A(b)(7)(D) of the FRA defines as a covered transaction a member bank's acceptance of securities issued by an affiliate as collateral security for a loan or extension of credit to any person or company.<sup>37</sup>

Section 223.24(c) of the rule provides an exemption for extensions of credit by a member bank that are secured by shares of an affiliated mutual fund. To qualify for the exemption, the transaction must meet several conditions. First, to ensure that the affiliate collateral is liquid and trades at a fair price, the affiliated mutual fund must be an open-end investment company that is registered with the SEC under the 1940 Act. Second, to ensure that the member bank can easily establish and monitor the value of the affiliate collateral, the affiliated mutual fund's shares serving as collateral for the extension of credit must have a publicly available market price. Third, to reduce the member bank's incentives to use these extensions of credit as a mechanism to support the affiliated mutual fund, the member bank and its affiliates must not own more than 5 percent of the fund's shares (excluding certain shares held in a fiduciary capacity). Finally, the proceeds of the extension of credit must not be used to purchase the affiliated mutual fund's shares serving as collateral or otherwise used to benefit an affiliate. In such circumstances, the member bank's extension of credit would be covered by section 23A's attribution rule. For example, a member bank proposes to lend \$100 to a nonaffiliate secured exclusively by eligible affiliated mutual fund securities. The member bank knows that the

nonaffiliate intends to use all the loan proceeds to purchase the eligible affiliated mutual fund securities that would serve as collateral for the loan. Under the attribution rule in section 223.16, the member bank must treat the loan to the nonaffiliate as a loan to an affiliate, and because securities issued by an affiliate are ineligible collateral under section 223.14, the loan would not be in compliance with section 223.14.

Under the rule, if the credit extension is secured exclusively by affiliate securities, then the transaction is valued at the full amount of the extension of credit. This approach reflects the difficulty of measuring the actual value of typically untraded and illiquid affiliate securities and conservatively assumes that the value of the securities is equal to the full value of the loan that the securities collateralize. An exception is provided to the general rule when the affiliate securities held as collateral have a ready market (as defined by section 223.42 of the rule). In that case, the transaction may be valued at the fair market value of the affiliate securities. The exception grants relief in those circumstances when the value of the affiliate securities is independently verifiable by reference to transactions occurring in a liquid market.<sup>38</sup>

Covered transactions of the second type, in which the credit extension is secured by affiliate securities and other collateral, are valued at the lesser of (1) the total value of the extension of credit minus the fair market value of the other collateral or (2) the fair market value of the affiliate securities (if the securities have a ready market). The rule's ready-market requirement applies regardless of the amount of affiliate collateral.<sup>39</sup>

### *Exemption for Shares Issued by an Affiliated Mutual Fund*

*A member bank's acquisition of an affiliate that becomes an operating subsidiary.* Section 223.31 (a)–(c) of the rule provides guidance to a member bank that acquires an affiliate. The first situation is when a member bank directly pur-

37. See 12 USC 371c(b)(7)(D). This covered transaction only arises when the member bank's loan is to a nonaffiliate. Under section 23A, the securities issued by an affiliate are not acceptable collateral for a loan or extension of credit to any affiliate. See 12 USC 371c(c)(4). If the proceeds of a loan that is secured by an affiliate's securities are transferred to an affiliate by the unaffiliated borrower (for example, to purchase assets or securities from the inventory of an affiliate), the loan should be treated as a loan to the affiliate, and the affiliate's securities cannot be used to meet the collateral requirements of sections 23A. The loan must then be secured with other collateral in an amount and of a type that meets the requirements of section 23A for loans by a member bank to an affiliate.

38. In either case, the transaction must comply with section 23B; that is, the member bank must obtain the same amount of affiliate securities as collateral on the credit extension that the bank would obtain if the collateral were not affiliate securities.

39. Under the rule, a member bank may use the higher of the two valuation options for these transactions if, for example, the bank does not have the procedures and systems in place to verify the fair market value of affiliate securities.

chases or otherwise acquires the affiliate's assets and assumes the affiliate's liabilities. In this case, the transaction is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any separate consideration paid by the member bank for the affiliate's assets (if any), plus the amount of any liabilities assumed by the bank in the transaction.

The rule provides that the acquisition by a member bank of a company that was an affiliate of the bank before the acquisition is treated as a purchase of assets from an affiliate if (1) as a result of the transaction, the company becomes an operating subsidiary of the bank and (2) the company has liabilities, or the bank gives cash or any other consideration in exchange for the securities. The rule also provides that these transactions must be valued initially at the sum of (1) the total amount of consideration given by the member bank in exchange for the securities and (2) the total liabilities of the company whose securities have been acquired by the member bank. In effect, the rule requires member banks to treat such share donations and purchases in the same manner as if the member bank had purchased the assets of the transferred company at a purchase price equal to the liabilities of the transferred company (plus any separate consideration paid by the bank for the shares). (See 12 CFR 223.31.)

Similarly, when an affiliate donates a controlling block of an affiliate's shares to a member bank, a covered transaction occurs if the affiliate has liabilities that the member bank assumes. For example, the parent holding company of a member bank contributes between 25 percent and 100 percent of the voting shares of a mortgage company to the member bank. The parent holding company retains no shares of the mortgage company. The member bank gives no consideration in exchange for the transferred shares. The mortgage company has total assets of \$300,000 and total liabilities of \$100,000. The mortgage company's assets do not include any loans to an affiliate of the member bank or any other asset that would represent a separate covered transaction for the member bank upon consummation of the share transfer. As a result of the transaction, the mortgage company becomes an operating subsidiary of the member bank. The transaction is treated as a purchase of the assets of the mortgage company by the member bank from an affiliate under paragraph (a) of section 223.31. The member bank initially must value the transaction at \$100,000, the total

amount of the liabilities of the mortgage company. Going forward, if the member bank pays off the liabilities, the member bank must continue to value the covered transaction at \$100,000. However, if the member bank sells \$15,000 of the transferred assets of the mortgage company or if \$15,000 of the transferred assets amortize, the member bank may value the covered transaction at \$85,000.

Another situation is when a member bank acquires an affiliate by merger. Because a merger with an affiliate generally results in the member bank's acquiring all the assets of the affiliate and assuming all the liabilities of the affiliate, this transaction is effectively equivalent to the purchase and assumption transaction described in the previous paragraph. Accordingly, the merger transaction also is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any consideration paid by the member bank for the affiliate's assets (if any), plus the amount of any liabilities assumed by the bank in the transaction.<sup>40</sup>

The assets and liabilities of an operating subsidiary of a member bank are treated in the rule as assets and liabilities of the bank itself for purposes of section 23A.<sup>41</sup> The rule only imposes asset-purchase treatment on affiliate share transfers when the company whose shares are being transferred to the member bank was an affiliate of the bank before the transfer. If the transferred company was not an affiliate before the transfer, it would not be appropriate to treat the share transfer as a purchase of assets from an affiliate. Similarly, the rule only requires asset-purchase treatment for affiliate share transfers when the transferred company becomes a subsidiary and not an affiliate of the member bank through the transfer.

If a member bank purchases, or receives a donation, of a partial interest in an entity that remains an affiliate, that transaction is treated as a purchase of, or investment in, securities issued by an affiliate. This type of transaction is valued

40. As noted, section 223.3(dd) of the rule makes explicit the Board's view that these merger transactions generally involve the purchase of assets by a member bank from an affiliate.

41. Because a member bank usually can merge a subsidiary into itself, transferring all the shares of an affiliate to a member bank often is functionally equivalent to a transaction in which the bank directly acquires the assets and assumes the liabilities of the affiliate. In a direct acquisition of assets and assumption of liabilities, the covered transaction amount would be equal to the total amount of liabilities assumed by the member bank.

according to the purchase price or GAAP carrying value. (See 12 CFR 223.23.)

### *Step-Transaction Exemption (Section 223.31(d) and (e))*

Under section 223.31(d) of the rule, an exemption is provided for certain step transactions that are treated as asset purchases under section 223.31(a) when an affiliate owned the transferred company for a limited period of time. Regulation W provides an exemption when a company acquires the stock of an unaffiliated company and, immediately after consummation of the acquisition, transfers the shares of the acquired company to the holding company's subsidiary member bank. For example, a BHC acquires 100 percent of the shares of an unaffiliated leasing company. At that time, the subsidiary member bank of the holding company notifies its appropriate federal banking agency and the Board of its intent to acquire the leasing company from its holding company. On the day after consummation of the acquisition, the holding company transfers all of the shares of the leasing company to the member bank. No material change in the business or financial condition of the leasing company occurs between the time of the holding company's acquisition and the member bank's acquisition. The leasing company has liabilities. The leasing company becomes an operating subsidiary of the member bank at the time of the transfer. This transfer by the holding company to the member bank, although deemed an asset purchase by the member bank from an affiliate under paragraph (a) of section 223.31, would qualify for the exemption in paragraph (d) of section 223.31.

The rule exempts these "step" transactions under certain conditions. First, the member bank must acquire the target company immediately after the company became an affiliate (by being acquired by the bank's holding company, for example).<sup>42</sup> The member bank must acquire the entire ownership position in the target company that its holding company acquired. Also, there must be no material change in the business or financial condition of the target company during the time between when the company becomes

an affiliate of the member bank and when the bank is in receipt of the company. Finally, the entire transaction must comply with the market-terms requirement of section 23B, and the bank must notify its appropriate federal banking agency and the Board, at or before the time that the target company becomes an affiliate of the bank, of its intent ultimately to acquire the target company.

Regulation W requires that the bank consummate the step transaction immediately to ensure the quality and fairness of the transaction. To the extent that the member bank acquires the target company some time after the company becomes an affiliate, the transaction looks less like a single transaction in which the bank acquires the target company and more like two separate transactions, the latter of which involves the bank acquiring assets from an affiliate.

The Board recognized, however, that banking organizations may need a reasonable amount of time to address legal, tax, and business issues relating to an acquisition. Regulation W thus permits member banks to avail themselves of the step-transaction exemption if the bank acquires the target company within three months after the target company becomes an affiliate so long as the appropriate federal banking agency for the bank has approved the longer time period.

The 100 percent ownership requirement (that the member bank must acquire the entire ownership position in the target company that its holding company acquired) prevents a holding company from keeping the good assets of the target company and transferring the bad assets to the holding company's subsidiary member bank. If a banking organization fails to meet the terms of the step-transaction exemption, the organization may be able to satisfy the conditions of the rule's internal-corporate-reorganization exemption or may be able to obtain a case-by-case exemption from the Board.

## Financial Subsidiaries

### *Section 23A Statutory Provisions for Financial Subsidiaries*

Section 23A has several special provisions that apply to covered transactions between a bank and its financial subsidiary. Section 23A defines a "financial subsidiary" as any company that is a subsidiary of a bank that would be a financial

42. This exemption can be used only by BHCs that are in existence at the time of the transaction. A BHC in formation cannot take advantage of the exemption. For example, a leasing company that applies to become a BHC cannot use the exemption to transfer its leasing assets to the bank.



subsidiary of a national bank under section 5136A of the Revised Statutes of the United States.<sup>43</sup> Section 5136A, in turn, defines a financial subsidiary of a national bank as any company that is controlled by one or more IDIs, other than (1) a subsidiary that engages solely in activities that national banks are permitted to engage in directly (and subject to the same terms and conditions that apply to national banks) or (2) a national bank that is specifically authorized by the express terms of a federal statute (other than section 5136A), such as an Edge Act corporation or an SBIC.<sup>44</sup> Section 5136A also prohibits a financial subsidiary of a national bank from engaging in insurance underwriting, real estate investment and development, or merchant banking activities.<sup>45</sup>

The GLB Act established several special provisions for the application of section 23A to financial subsidiaries of a bank. First, the 10 percent quantitative limit of section 23A between a bank and any individual affiliate does not apply to covered transactions between a bank and any individual financial subsidiary of the bank. Accordingly, a bank may engage in covered transactions with any individual financial subsidiary up to 20 percent of the bank's capital stock and surplus. In addition, for purposes of section 23A, the amount of a bank's investment in its financial subsidiary should not include the retained earnings of the financial subsidiary.<sup>46</sup>

Section 23A generally applies only to transactions between (1) a bank and an affiliate of the bank and (2) a bank and a third party in which some benefit from either type of transaction accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. Section 23A establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a bank and another affiliate of the bank. First, the FRA provides that any purchase of, or investment in, the securities of a bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem a loan or other extensions of credit made by a bank's affiliate to any financial subsidiary of a bank to be an extension of credit by the bank to the

financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasion.

### *Regulation W Provisions for Financial Subsidiaries*

Regulation W (1) defines a financial subsidiary of a bank, (2) exempts certain companies from the definition, and (3) sets forth special valuation and other rules for financial subsidiaries. (See sections 223.3(a)(8), 223.3(p), and 223.32 of the rule.) In section 223.32, Regulation W also includes, several special rules that apply to transactions for financial subsidiaries.

*Applicability of the 10 percent quantitative limit to transactions with a financial subsidiary.* First, section 223.32(a) of the rule provides that the 10 percent quantitative limit in section 23A does not apply with respect to covered transactions between a member bank and any individual financial subsidiary of the bank. A member bank's aggregate amount of covered transactions with any individual financial subsidiary of the bank may exceed 10 percent of the bank's capital stock and surplus.<sup>47</sup> A member bank's covered transactions with its financial subsidiaries, however, are subject to the 20 percent quantitative limit in section 23A. Thus, a member bank may not engage in a covered transaction with any affiliate (including a financial subsidiary) if the bank's aggregate amount of covered transactions with all affiliates (including financial subsidiaries) would exceed 20 percent of the bank's capital stock and surplus.

The Board notes that the exemption from the 10 percent limit for investments by a member bank in its own financial subsidiary does not apply to investments by a bank in the financial subsidiary of an affiliated depository institution. Although the financial subsidiary of an affiliated depository institution is an affiliate of the bank for purposes of sections 23A and 23B, the GLB Act states that only "covered transactions between a bank and any individual financial subsidiary of the bank" are not subject to the 10 percent limit in section 23A.<sup>48</sup> A member bank may not engage in a covered transaction

43. 12 USC 24a(g)(3).

44. 12 USC 24a(2).

45. 12 USC 371c(c)(1).

46. GLB Act section 121(b)(1), codified at 12 USC 371c(e)(3)(B)).

47. Section 223.11 also indicates that covered transactions between a member bank and its financial subsidiary are exempt from the 10 percent limit.

48. See 12 USC 371c(e)(3)(A).

with the financial subsidiary of an affiliated depository institution if the aggregate amount of the member bank's covered transactions with that financial subsidiary would exceed 10 percent of the bank's capital stock and surplus.

*Valuation of investments in securities issued by a financial subsidiary.* Because financial subsidiaries of a member bank are considered affiliates of the bank for purposes of section 23A, a member bank's purchases of, and investments in, the securities of its financial subsidiary are covered transactions under the statute. The GLB Act further provides that a member bank's investment in its own financial subsidiary, for purposes of section 23A, shall not include the retained earnings of the financial subsidiary.<sup>49</sup> In light of this statutory provision, section 223.32(b) of Regulation W contains a special valuation rule for investments by a member bank in the securities of its own financial subsidiary.<sup>50</sup> Such investments must be valued at the greater of (1) the price paid by the member bank for the securities or (2) the carrying value of the securities on the financial statements of the member bank (determined in accordance with GAAP but without reflecting the bank's pro rata share of any earnings retained or losses incurred by the financial subsidiary after the bank's acquisition of the securities).<sup>51</sup>

This valuation rule differs from the general valuation rule for investments in securities issued by an affiliate in that the financial subsidiary rule permits, consistent with the GLB Act, that the carrying value of the investment be computed without consideration of the retained earnings or losses of the financial subsidiary since the time of the member bank's investment. As a result of this rule, the covered transaction amount for a member bank's investment in securities issued by its financial subsidiary generally would not increase after the investment was made except if

the member bank made an additional capital contribution to the subsidiary or purchased additional securities of the subsidiary.

The following examples were designed to assist banks in valuing investments in securities issued by a financial subsidiary of the bank. Each example involves a securities underwriter that becomes a financial subsidiary of the bank after the transactions described below.

*Initial valuation.*

- *Direct acquisition by a bank.* A bank pays \$500 to acquire 100 percent of the shares of a securities underwriter. The initial carrying value of the shares on the member bank's parent-only GAAP financial statements is \$500. The member bank initially must value the investment at \$500.
- *Contribution of a financial subsidiary to a bank.* The parent holding company of a member bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at \$500 and immediately contributes the shares to the member bank. The member bank gives no consideration in exchange for the shares. The bank initially must value the investment at the carrying value of the shares on the bank's parent-only GAAP financial statements. Under GAAP, the bank's initial carrying value of the shares would be \$500.

*Carrying value not adjusted for earnings and losses of the financial subsidiary.* A bank and its parent holding company engage in a transaction whereby the member bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at \$500. The bank initially values the investment at \$500. In the following year, the securities underwriter earns \$25 in profit, which is added to its retained earnings. The bank's investment of the shares of the underwriter is not adjusted for purposes of section 23A and Regulation W, and the bank's investment continues to be valued at \$500. If, however, the bank contributes \$100 of additional capital to the securities underwriter, the bank must value the aggregate investment at \$600.

*Anti-evasion rules as they pertain to financial subsidiaries.* Section 23A generally applies only to transactions between a bank and an affiliate of the bank and transactions between a member bank and a third party when some benefit of the

49. GLB Act section 121(b)(1). (See 12 USC 371c(e)(3)(B).)

50. The rule's special valuation formula for investments by a member bank in its own financial subsidiary does not apply to investments by a member bank in a financial subsidiary of an affiliated depository institution. Such investments must be valued using the general valuation formula set forth in section 223.23 for investments in securities issued by an affiliate and, further, may trigger the anti-evasion rule contained in section 223.32(c)(1) of the rule.

51. The rule also makes clear that if a financial subsidiary is consolidated with its parent member bank under GAAP, the carrying value of the bank's investment in the financial subsidiary shall be determined based on parent-only financial statements of the bank.

transaction accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. The GLB Act establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a member bank and another affiliate of the bank.<sup>52</sup> First, the GLB Act provides that any purchase of, or investment in, securities issued by a member bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem an extension of credit made by a member bank's affiliate to any financial subsidiary of the bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasions of the FRA or the GLB Act. Section 223.32(c) of the rule incorporates both of these provisions.

The Board exercised its authority under the second anti-evasion rule by stating that an extension of credit to a financial subsidiary of a bank by an affiliate of the bank would be treated as an extension of credit by the bank itself to the financial subsidiary if the extension of credit is treated as regulatory capital of the financial subsidiary. An example of the kind of credit extension covered by this provision would be a subordinated loan to a financial subsidiary that is a securities broker-dealer where the loan is treated as capital of the subsidiary under the SEC's net capital rules. Treating such an extension of credit as a covered transaction is appropriate because the extension of credit by the affiliate has a similar effect on the subsidiary's regulatory capital as an equity investment by the affiliate, which is treated as a covered transaction by the terms of the GLB Act (as described above). The rule generally does not prevent a BHC or other affiliate of a member bank from providing financial support to a financial subsidiary of the bank in the form of a senior or secured loan.

## Collateral for Certain Transactions with Affiliates

Section 23A requires a member bank's use of collateral for certain transactions between a

52. GLB Act section 121(b)(1), codified at 12 USC 371c(e)(4).

member bank and its affiliates.<sup>53</sup> Each loan or extension of credit to an affiliate<sup>54</sup> or guarantee, acceptance, or letter of credit issued on behalf of an affiliate (herein referred to as credit transactions) by a member bank or its subsidiary must be secured at the time of the transaction by collateral. The required collateral varies<sup>55</sup> depending on the type of collateral used to secure the transaction.<sup>56</sup> The specific collateral requirements are—

1. 100 percent of the amount of the credit extended if the collateral is composed of
  - a. obligations of the United States or its agencies;
  - b. obligations fully guaranteed by the United States or its agencies as to principal and interest;
  - c. notes, drafts, bills of exchange, or banker's acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank;<sup>57</sup> or
  - d. a segregated, earmarked deposit account with the member bank that is for the sole purpose of securing a credit transaction between the member bank and its affiliates and is identified as such;
2. 110 percent of the amount of the credit extended if the collateral is composed of obligations of any state or political subdivision of any state;
3. 120 percent of the amount of the credit extended if the collateral is composed of other debt instruments, including receivables; or
4. 130 percent of the amount of the credit extended if the collateral is composed of stock, leases, or other real or personal property.

For example, a member bank makes a \$1,000 loan to an affiliate. The affiliate posts as collateral for the loan \$500 in U.S. Treasury securities, \$480 in corporate debt securities, and \$130 in real estate. The loan satisfies the collateral requirements of this section because \$500 of the

53. The bank must perfect the security interest in the collateral (*Fitzpatrick v. FDIC*, 765 F.2d 569 (6th Cir. 1985)). A purchase of assets from an affiliate does not require collateral.

54. 12 USC 371c(b)(7).

55. "Credit extended" means the loan or extension of credit, guarantee, acceptance, or letter of credit.

56. 12 USC 371c(c)(1).

57. Regulation A includes a representative list of acceptable government obligations (12 CFR 201.108).

loan is 100 percent secured by obligations of the United States, \$400 of the loan is 120 percent secured by debt instruments, and \$100 of the loan is 130 percent secured by real estate. The statute prohibits a member bank from counting a low-quality asset toward section 23A's collateral requirements for credit transactions with affiliates.<sup>58</sup> A member bank must maintain a perfected security interest at all times in the collateral that secures the credit transaction.

## Collateral Requirements in Regulation W

The collateral requirements for credit transactions are found in section 223.14 of the rule. Section 223.14(a) requires that a bank meet the collateral requirements only at the inception of a credit transaction with an affiliate. Although the section only requires that a member bank meet the collateral requirements at the inception, section 23B may require the collateral to be increased if the collateral decreases in value and the member bank would require additional collateral from a third party. A low-quality asset can be used as extra collateral, if it cannot satisfy the statute or the regulation's collateral requirements.

*Deposit Account Collateral.* Under section 23A, a member bank may satisfy the collateral requirements of the statute by securing a credit transaction with an affiliate with a "segregated, earmarked deposit account" maintained with the bank in an amount equal to 100 percent of the credit extended.<sup>59</sup>

Member banks may secure covered transactions with omnibus deposit accounts so long as the member bank takes steps to ensure that the omnibus deposit accounts fully secure the relevant covered transactions. Such steps might include substantial overcollateralization or the use of subaccounts or other recordkeeping devices to match deposits with covered transactions. To obtain full credit for any deposit accounts taken as section 23A collateral, member banks must ensure that they have a perfected, first-priority security interest in the accounts. (See section 223.14(b)(1)(i)(D).)

*Ineligible collateral.* The purpose of section

23A's collateral requirements is to ensure that member banks that engage in credit transactions with affiliates have legal recourse, in the event of affiliate default, to tangible assets with a value at least equal to the amount of the credit extended. The statute recognizes that certain types of assets are not appropriate to serve as collateral for credit transactions with an affiliate. In particular, the statute provides that low-quality assets and securities issued by an affiliate are not eligible collateral for such covered transactions.<sup>60</sup>

Under section 223.14(c) of the rule, intangible assets also are not deemed acceptable to meet the collateral requirements imposed by section 23A.<sup>61</sup> Intangible assets, including servicing assets, are particularly hard to value, and a member bank may have significant difficulty in collecting and selling such assets in a reasonable period of time.

Section 23A(c) requires that credit transactions with an affiliate be "secured" by collateral. A credit transaction between a member bank and an affiliate supported only by a guarantee or letter of credit from a third party does not meet the statutory requirement that the credit transaction be secured by collateral. Guarantees and letters of credit often are subject to material adverse change clauses and other covenants that allow the issuer of the guarantee or letter of credit to deny coverage. Letters of credit and guarantees are not balance-sheet assets under GAAP and, accordingly, would not constitute "real or personal property" under section 23A. There is a particularly significant risk that a member bank may have difficulty collecting on a guarantee or letter of credit provided by a nonaffiliate on behalf of an affiliate of the bank. Accordingly, guarantees and letters of credit are not acceptable section 23A collateral.<sup>62</sup>

As noted above, section 23A prohibits a member bank from accepting securities issued by an affiliate as collateral for an extension of credit to any affiliate. The rule clarifies that securities issued by the member bank itself also are not eligible collateral to secure a credit

60. 12 USC 371c (c)(3) and (4).

61. The rule does not confine the definition of intangible assets by reference to GAAP.

62. The rule also provides that instruments "similar" to guarantees and letters of credit are ineligible collateral. For example, in the Board's view, a member bank cannot satisfy section 23A's collateral requirements by purchasing credit protection in the form of a credit-default swap referencing the affiliate's obligation.

58. 12 USC 371c(c)(3).

59. 12 USC 371c(c)(1)(A)(iv).

transaction with an affiliate. Equity securities issued by a lending member bank, and debt securities issued by a lending member bank that count as regulatory capital of the bank, are not eligible collateral under section 23A. If a member bank were forced to foreclose on a credit transaction with an affiliate secured by such securities, the bank may be unwilling to liquidate the collateral promptly to recover on the credit transaction because the sale might depress the price of the bank's outstanding securities or result in a change in control of the bank. In addition, to the extent that a member bank is unable or unwilling to sell such securities acquired through foreclosure, the transaction would likely result in a reduction in the bank's capital, thereby offsetting any potential benefit provided by the collateral.

*Perfection and priority.* Under section 223.14(d) of the rule, a member bank's security interest in any collateral required by section 23A must be perfected in accordance with applicable law to ensure that a member bank has good access to the assets serving as collateral for its credit transactions with affiliates. This requirement ensures that the member bank has the legal right to realize on the collateral in the case of default, including a default resulting from the affiliate's insolvency or liquidation. A member bank also is required to either obtain a first-priority security interest in the required collateral or deduct from the amount of collateral obtained by the bank the lesser of (1) the amount of any security interests in the collateral that are senior to that obtained by the bank or (2) the amount of any credits secured by the collateral that are senior to that of the bank. For example, if a member bank lends \$100 to an affiliate and takes as collateral a second lien on a parcel of real estate worth \$200, the arrangement would only satisfy the collateral requirements of section 23A if the affiliate owed the holder of the first lien \$70 or less (a credit transaction secured by real estate must be secured at 130 percent of the amount of the transaction).

The rule includes the following example of how to compute the section 23A collateral value of a junior lien: A member bank makes a \$2,000 loan to an affiliate. The affiliate grants the member bank a second-priority security interest in a piece of real estate valued at \$3,000. Another institution that previously lent \$1,000 to the affiliate has a first-priority security interest in the entire parcel of real estate. This transac-

tion is not in compliance with the collateral requirements of this section. Because of the existence of the prior third-party lien on the real estate, the effective value of the real estate collateral for the member bank for purposes of this section is only \$2,000—\$600 less than the amount of real estate collateral required by this section for the transaction ( $\$2,000 \times 130 \text{ percent} = \$2,600$ ).

*Unused portion of an extension of credit.* Section 23A requires that the "amount" of an extension of credit be secured by the statutorily prescribed levels of collateral. Under the statute, if a member bank provides a line of credit to an affiliate, it must secure the full amount of the line of credit throughout the life of the credit. Section 223.14(f)(2) of the rule, however, provides an exemption to the collateral requirements of section 23A for the unused portion of an extension of credit to an affiliate so long as the member bank does not have any legal obligation to advance additional funds under the credit facility until the affiliate has posted the amount of collateral required by the statute with respect to the entire used portion of the extension of credit.<sup>63</sup> In such credit arrangements, securing the unused portion of the credit line is unnecessary from a safety-and-soundness perspective because the affiliate cannot require the member bank to advance additional funds without posting the additional collateral required by section 23A. If a member bank voluntarily advances additional funds under such a credit arrangement without obtaining the additional collateral required under section 23A to secure the entire used amount (despite its lack of a legal obligation to make such an advance), the Board views this action as a violation of the collateral requirements of the statute. The entire amount of the line of credit counts against the bank's quantitative limit, even if the line does not need to be secured.

*Purchasing affiliate debt securities in the secondary market.* A member bank's investment in the debt securities issued by an affiliate is an extension of credit by the bank to the affiliate and thus is subject to section 23A's collateral requirements. Section 223.14(f)(3) of the rule provides an exemption that permits member

63. This does not apply to guarantees, acceptances, and letters of credit issued on behalf of an affiliate. These instruments must be fully collateralized at inception.

banks in certain circumstances to purchase debt securities issued by an affiliate without satisfying the collateral requirements of section 23A. The exemption is available where a member bank purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction. When a member bank buys an affiliate's debt securities in a bona fide secondary-market transaction, the risk that the purchase is designed to shore up an ailing affiliate is reduced. Any purchase of affiliate debt securities that qualifies for this exemption would still remain subject to the quantitative limits of section 23A and the market-terms requirement of section 23B. In analyzing a member bank's good faith under this exemption transaction, examiners should look at the time elapsed between the original issuance of the affiliate's debt securities and the bank's purchase, the existence of any relevant agreements or relationships between the bank and the third-party seller of the affiliate's debt securities, any history of bank financing of the affiliate, and any other relevant information.

*Credit transactions with nonaffiliates that become affiliates.* Banks sometimes lend money to, or issue guarantees on behalf of, unaffiliated companies that later become affiliates of the bank. Section 223.21(b)(2) provides transition rules that exempt credit transactions from the collateral requirements in situations in which the member bank entered into the transactions with the nonaffiliate at least one year before the nonaffiliate became an affiliate of the bank.

For example, a member bank with capital stock and surplus of \$1,000 and no outstanding covered transactions makes a \$120 unsecured loan to a nonaffiliate. The member bank does not make the loan in contemplation of the nonaffiliate becoming an affiliate. Nine months later, the member bank's holding company purchases all the stock of the nonaffiliate, thereby making the nonaffiliate an affiliate of the member bank. The member bank is not in violation of the quantitative limits of the rule's section 223.11 or 223.12 at the time of the stock acquisition. The member bank is, however, prohibited from engaging in any additional covered transactions with the new affiliate at least until such time as the value of the loan transaction falls below 10 percent of the member bank's capital stock and surplus. The transaction counts towards the 20 percent limit for transactions for all affiliates. In addition, the member bank must

bring the loan into compliance with the collateral requirements of section 223.14 promptly after the stock acquisition. Transactions with nonaffiliates in contemplation of the nonaffiliate becoming an affiliate must meet the quantitative and collateral requirements of the rule at the time of the inception of the credit transaction and of the affiliation.

## Limitations on Collateral

Member banks may accept as collateral for covered transactions receivables, leases, or other real or personal property.<sup>64</sup> The following are limitations and collateral restrictions:

1. Any collateral that is subsequently retired or amortized must be replaced by additional eligible collateral. This is done to keep the percentage of the collateral value relative to the amount of the outstanding loan or extension of credit, guarantee, acceptance, or letter of credit equal to the minimum percentage that was required at the inception of the transaction.
2. A low-quality asset is not acceptable as collateral for a loan or extension of credit to, or for a guarantee, acceptance, or letter of credit issued on behalf of, an affiliate.
3. Securities issued by an affiliate of an IDI shall not be acceptable as collateral for a loan or extension of credit to, or for a guarantee, acceptance, or letter of credit issued on behalf of, that affiliate or any other affiliate of the IDI. The above collateral requirements are not applicable to an acceptance that is already fully secured either by attached documents or by other property that is involved in the transaction and has an ascertainable market value.

<sup>64</sup> As noted above, letters of credit and mortgage servicing rights may not be accepted as collateral for purposes of section 23A. See 12 CFR 223.14(c)(4) and (5).

## Derivative Transactions Between Insured Depository Institutions and Their Affiliates

The GLB Act required the Board to adopt rules under section 23A of the FRA that would address as covered transactions (1) credit exposure arising out of derivative transactions between member banks and their affiliates and (2) intraday extensions of credit by member banks to their affiliates (12 USC 371c(f)(3)).

Derivative transactions between a bank and its affiliates generally arise either from the risk-management needs of the bank or the affiliate. Transactions arising from the bank's needs typically arise when a bank enters into a swap or other derivative contract with a customer but chooses not to hedge directly the market risk generated by the derivative contract or is unable to hedge the risk directly because the bank is not authorized to hold the hedging asset. In order to manage the market risk, the bank may have an affiliate acquire the hedging asset. The bank would then do a "bridging" derivative transaction between itself and the affiliate maintaining the hedge.

Other derivative transactions between a member bank and its affiliate are affiliate-driven. A bank's affiliate may enter into an interest-rate or foreign-exchange derivative with the bank in order to accomplish the asset-liability management goals of the affiliate. For example, a BHC may hold a substantial amount of floating-rate assets but issue fixed-rate debt securities to obtain cheaper funding. The BHC may then enter into a fixed-to-floating interest-rate swap with its subsidiary bank to reduce the holding company's interest-rate risk.

Banks and their affiliates that seek to enter into derivative transactions for hedging (or risk-taking) purposes could enter into the desired derivatives with unaffiliated companies. Banks and their affiliates often choose to use each other as their derivative counterparties, however, in order to maximize the profits of, and manage risks within, the consolidated financial group.

## Regulation W on Derivative Transactions

Regulation W does not require most derivative transactions to meet the quantitative and collat-

eral requirements of section 23A. Instead, the rule requires the member bank to establish and maintain policies and procedures designed to manage the credit exposure arising from the derivative. These policies and procedures require, at a minimum, that the bank monitor and control its exposure to its affiliates by imposing appropriate credit controls and collateral requirements.

Regulation W provides that credit derivatives between an institution and an unaffiliated third party that reference the obligations of an affiliate of the institution, and that are the functional equivalent of a guarantee by the institution on behalf of an affiliate, should be treated as a guarantee by the institution on behalf of an affiliate for the purposes of section 23A.

## Section 23B and Regulation W Regarding Derivative Transactions

Derivative transactions between a member bank and an affiliate are subject to section 23B of the FRA under the express terms of the statute.<sup>65</sup> In this regard, section 23B requires a member bank to treat an affiliate no better than a *similarly situated* nonaffiliate. Section 23B generally does not allow a member bank to use with an affiliate the terms and conditions it uses with its most creditworthy unaffiliated customer, unless the bank can demonstrate that the affiliate is of comparable creditworthiness as the bank's most creditworthy unaffiliated customer. Instead, section 23B requires that an affiliate be treated comparably (with respect to terms, conditions, and credit limits) to the majority of third-party customers engaged in the same business, and having comparable credit quality and size as the affiliate. Because a bank generally has the strongest credit rating within a holding company, the Board generally would not expect an affiliate to obtain better terms and conditions from a member bank than the member bank receives from its major unaffiliated counterparties. In addition, market terms for derivatives among major financial institutions generally include daily marks to market and two-way collateralization above a

<sup>65</sup> In addition to applying to covered transactions, as defined in section 23A of the FRA, the market-terms requirement of section 23B of the FRA applies broadly to, among other things, "[t]he payment of money or the furnishing of services to an affiliate under contract, lease or otherwise" (12 USC 371c-1(a)(2)(C)). Institution-affiliate derivatives generally involve a contract or agreement to pay money to the affiliate or furnish risk-management services to the affiliate.

relatively small exposure threshold.

## Covering Derivatives That Are the Functional Equivalent of a Guarantee

Although most derivatives are not treated as covered transactions, section 223.33 of the rule provides that credit derivatives between a member bank and a nonaffiliate in which the bank protects the nonaffiliate from a default on, or a decline in the value of, an obligation of an affiliate of the bank are covered transactions under section 23A. Such derivative transactions are viewed as guarantees by a member bank on behalf of an affiliate (and, hence, are covered transactions) under section 23A.

The rule provides that these credit derivatives are covered transactions under section 23A and gives several examples.<sup>66</sup> A member bank is not allowed to reduce its covered-transaction amount for these derivatives to reflect hedging positions established by the bank with third parties. A credit derivative is treated as a covered transaction only to the extent that the derivative provides credit protection with respect to obligations of an affiliate of the member bank.

## Exemptions from Section 23A

Section 23A exempts seven transactions or relations from its quantitative limits and collateral requirements.<sup>67</sup> Regulation W, subpart E, clarifies certain of these exemptions and exempts a number of additional types of transactions.

The Board reserves the right to revoke or modify any additional exemption granted by the Board in Regulation W, if the Board finds that the exemption is resulting in unsafe or unsound banking practices. The Board also reserves the right to terminate the eligibility of a particular member bank to use any such exemption if the bank's use of the exemption is resulting in unsafe or unsound banking practices.

66. This does not apply to guarantees, acceptances, and letters of credit issued on behalf of an affiliate. These instruments must be fully collateralized at inception. In most instances, the covered-transaction amount for such a credit derivative would be the notional principal amount of the derivative.

67. 12 USC 371c(d).

## *Covered Transactions Exempt from the Quantitative Limits and Collateral Requirements*

Under the rule's section 223.41, the quantitative limits (sections 223.11 and 223.12) and the collateral requirements (section 223.14) do not apply to the following transactions. The transactions are, however, subject to the safety-and-soundness requirement (section 223.13) and the prohibition on the purchase of a low-quality asset (section 223.15).

- *Parent institution/subsidiary institution transactions.* Transactions with a depository institution if the member bank controls 80 percent or more of the voting securities of the depository institution or the depository institution controls 80 percent or more of the voting securities of the member bank.
- *Purchase of loans on a nonrecourse basis from an affiliated depository institution.* Banks that are commonly controlled (i.e., at least 25 percent common ownership) can purchase loans on a nonrecourse basis. This allows chain banks and banks in companies that are not owned 80 percent by the same company to achieve the same efficiency as sister banks.

*Sister-bank exemption (section 223.41(b)).* Regulation W exempts transactions with a federally IDI if the same company controls 80 percent or more of the voting securities of the member bank and the depository institution.<sup>68</sup> In addition, the statute provides that covered transactions between sister banks must be consistent with safe and sound banking practices.<sup>69</sup>

The sister-bank exemption generally applies only to transactions between IDIs.<sup>70</sup> The rule's definition of affiliate excludes uninsured depository institution subsidiaries of a member bank. Covered transactions between a member bank

68. Banks that are affiliated in this manner are referred to as "sister banks." Sister banks can improve their efficiency through intercorporate transfers under this exception. Also, "company" in this context is not limited to a BHC. For example, if a retail corporation owns two credit card banks, the two credit card banks would be sister banks, although owned by a retail corporation, and the sister-bank exemption could be used for transactions between two credit card banks.  
69. 12 USC 371c(a)(4).

70. A member bank and its operating subsidiaries are considered a single unit for purposes of section 23A. Under the statute and the regulation, transactions between a member bank (or its operating subsidiary) and the operating subsidiary of a sister IDI generally qualify for the sister-bank exemption.



and a parent uninsured depository institution or a commonly controlled uninsured depository institution, under the rule, generally would be subject to section 23A whereas covered transactions between a member bank and a subsidiary uninsured depository institution would not be subject to section 23A.<sup>71</sup>

The sister-bank exemption, by its terms, only exempts transactions by a member bank with a sister-bank affiliate; hence, the sister-bank exemption cannot exempt a member bank's extension of credit or other covered transaction to an affiliate that is not a sister bank (even if the extension of credit was purchased from a sister bank). For example, a member bank purchases from Sister-Bank Affiliate A a loan to Affiliate B in a purchase that qualifies for the sister-bank exemption in section 23A. The member bank's asset purchase from Sister-Bank Affiliate A would be an exempt covered transaction under section 223.41(b), but the member bank also would have acquired an extension of credit to Affiliate B, which would be a covered transaction between the member bank and Affiliate B under section 223.3(h)(1) that does not qualify for the sister-bank exemption.

*Internal corporate reorganizations.* Section 223.41(d) of Regulation W provides an exemption for asset purchases by a bank from an affiliate that are part of a one-time internal corporate reorganization of a banking organization.<sup>72</sup> The exemption includes purchases of assets in connection with a transfer of securities issued by an affiliate to a member bank, as described in section 223.31(a).

Under this exemption, a member bank would be permitted to purchase assets (other than low-quality assets) from an affiliate (including in connection with an affiliate share transfer that section 223.31 of the rule treats as a purchase of assets) exempt from the quantitative limits of section 23A if the following conditions are met.

First, the purchase must be part of an internal corporate reorganization of a holding company that involves the transfer of all or substantially all of the shares or assets of an affiliate or of a

division or department of an affiliate to an IDI.<sup>73</sup> The asset purchase must not be part of a series of periodic, ordinary-course asset transfers from an affiliate to a member bank.<sup>74</sup> Second, the member bank's holding company must provide the Board with contemporaneous notice of the transaction and must commit to the Board to make the bank whole, for a period of two years, for any transferred assets that become low-quality assets.<sup>75</sup> Third, a majority of the member bank's directors must review and approve the transaction before consummation. Fourth, the section 23A value of the covered transaction must be less than 10 percent of the member bank's capital stock and surplus (or up to 25 percent of the bank's capital stock and surplus with the prior approval of the appropriate federal banking agency). Fifth, the holding company and all its subsidiary depository institutions must be well capitalized and well managed and must remain well capitalized upon consummation of the transaction.

#### *Covered Transactions Also Exempt from the Quantitative Limits, Collateral Requirements, and Low-Quality-Asset Prohibition*

The quantitative limits (sections 223.11 and 223.12), the collateral requirements (section 223.14), and the prohibition on the purchase of

73. The notice also must describe the primary business activities of the affiliate whose shares or assets are being transferred to the member bank and must indicate the anticipated date of the reorganization.

74. The IDI must provide the Board, as well as the appropriate federal agency, a notice that describes the primary business activities of the affiliate whose shares or assets are being transferred to the IDI and must indicate the anticipated date of the reorganization.

75. The holding company can meet these criteria either by repurchasing the assets at book value plus any write-down that has been taken or by making a quarterly cash contribution to the bank equal to the book value plus any write-downs that have been taken by the bank. The purchase or payment must be made within 30 days of each quarter end. In addition, if a cash payment is made, the member bank will hold an amount of risk-based capital equal to the book value of any transferred asset that becomes low-quality so long as the bank retains ownership of the transferred asset. For example, under this dollar-for-dollar capital requirement, the risk-based capital charge for each transferred low-quality loan asset would be 100 percent (equivalent to a 1250 percent risk weight) rather than the 8 percent requirement (equivalent to a 100 percent risk weight) that would apply to a similar defaulted loan asset that is not a part of the transferred asset pool. See Board letter dated December 21, 2007, to Andres L Navarrete (Capital One Financial Corp.)

71. The sister-bank exemption in section 23A does not allow a member bank to avoid any restrictions on sister-bank transactions that may apply to the bank under the prompt-corrective-action framework set forth in section 38 of the FDI Act (12 USC. 1831o) and regulations adopted thereunder by the bank's appropriate federal banking agency.

72. See 1998 *Fed. Res. Bull.* 985 and 1013–14.

a low-quality asset (section 223.15) do not apply to the following exempted transactions. (See section 223.42.) The transactions are, however, subject to the safety-and-soundness requirement (section 223.13) and certain conditions. Detailed conditions or restrictions pertaining to these exemptions are discussed after this list.

1. Making correspondent banking deposits in an affiliated depository institution (as defined in section 3 of the FDI Act (12 USC 1813)) or an affiliated foreign bank that represent an ongoing, working balance maintained in the ordinary course of correspondent business
2. Giving immediate credit to an affiliate for uncollected items received in the ordinary course of business
3. Transactions secured by cash or U.S. government securities
4. Purchasing securities of a servicing affiliate as defined by the BHC Act
5. Purchasing certain liquid assets
6. Purchasing certain marketable securities
7. Purchasing certain municipal securities
8. Purchasing from an affiliate an extension of credit subject to a repurchase agreement that was originated by a member bank and sold to the affiliate subject to a repurchase agreement or with recourse
9. Asset purchases from an affiliate by a newly formed member bank, if the appropriate federal banking agency for the member bank has approved the asset purchase in writing in connection with the review of the formation of the member bank
10. Transactions approved under the Bank Merger Act that involve affiliated federally IDIs and the U.S. branches and agencies of a foreign bank
11. Purchasing, on a nonrecourse basis, an extension of credit from an affiliate
12. Intraday extensions of credit
13. Riskless-principal transactions

*Correspondent banking.* Section 23A exempts from its quantitative limits and collateral requirements a deposit by a member bank in an affiliated bank or affiliated foreign bank that is made in the ordinary course of correspondent business, subject to any restrictions that the Board may impose.<sup>76</sup> Section 223.42(a) of the rule further provides that such deposits must represent ongoing, working balances maintained

by the member bank in the ordinary course of conducting the correspondent business.<sup>77</sup> Although not required by section 23A or the Home Owners' Loan Act (HOLA), the rule also provides that correspondent deposits in an affiliated insured savings association are exempt if they otherwise meet the requirements of the exemption.

*Secured credit transactions.* Section 23A and section 223.42(c) of the rule exempt any credit transaction by a member bank with an affiliate that is "fully secured" by obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest.<sup>78</sup> A deposit account meets the "segregated, earmarked" requirement only if the account exists for the sole purpose of securing credit transactions between the member bank and its affiliates and is so identified. Under section 23A, if U.S. government obligations or deposit accounts are sufficient to fully secure a credit transaction, then the transaction is completely exempt from the quantitative limits of the statute. If, however, the U.S. government obligations or deposit accounts represent less than full security for the credit transaction, then the amount of U.S. government obligations or deposits counts toward the collateral requirements of section 23A, but no part of the transaction is exempt from the statute's quantitative limits.

The exemption provides that a credit transaction with an affiliate will be exempt "to the extent that the transaction is and remains secured" by appropriate (d)(4) collateral. If a member bank makes a \$100 nonamortizing term loan to an affiliate that is secured by \$50 of U.S. Treasury securities and \$75 of real estate, the value of the covered transaction will be \$50. If the market value of the U.S. Treasury securities falls to \$45 during the life of the loan, the value of the covered transaction would increase to \$55. The Board expects member banks that use this expanded (d)(4) exemption to review the market value of their U.S. government obligations collateral regularly to ensure compliance with the exemption.

<sup>77</sup> Unlike the sister-bank exemption, the exemption for correspondent banking deposits applies to deposits placed by a member bank in an uninsured depository institution or foreign bank.

<sup>78</sup> 12 U.S.C. 371c(d)(4). A partial list of such obligations can be found at 12 CFR 201.108.

<sup>76</sup> 12 USC 371c(d)(2).

*Purchases of assets with readily identifiable market quotes.* Section 23A(d)(6) exempts the purchase of assets by a member bank from an affiliate if the assets have a “readily identifiable and publicly available market quotation” and are purchased at their current market quotation. The rule (section 223.42(e)) limits the availability of this exemption (the (d)(6) exemption) to purchases of assets with market prices that are recorded in widely disseminated publications that are readily available to the general public, such as newspapers with a national circulation. Because as a general matter only exchange-traded assets are recorded in such publications, this test has ensured that the qualifying assets are traded actively enough to have a true “market quotation” and that examiners can verify that the assets are purchased at their current market quotation. The rule applies if the asset is purchased at or below the asset’s current market quotation.<sup>79</sup>

If a member bank purchases from one affiliate securities issued by another affiliate, the bank has engaged in two types of covered transactions: a purchase of securities from an affiliate and the investment in securities issued by an affiliate. Under the rule, although the (d)(6) exemption may exempt the one-time asset purchase from the first affiliate, it would not exempt the ongoing investment in securities being issued by the second affiliate.

The (d)(6) exemption may apply to a purchase of assets that are not traded on an exchange. In particular, purchases of foreign exchange, gold, and silver, and purchases of over-the-counter (OTC) securities and derivative contracts, whose prices are recorded in widely disseminated publications, may qualify for the (d)(6) exemption.

*Purchases of Certain Marketable Securities under Regulation W.* Regulation W provided an additional exemption from section 23A for certain purchases of securities by a member bank from an affiliate. The rule expanded the statutory (d)(6) exemption to allow a member bank to purchase securities from an affiliate based on price quotes obtained from certain electronic

services so long as, among other things, the selling affiliate is a broker–dealer registered with the SEC, the securities have a ready market and are eligible for purchase by state member banks, the securities are not purchased within 30 days of an underwriting (if an affiliate of the bank is an underwriter of the securities), and the securities are not issued by an affiliate.

- *Broker–Dealer Requirement.* Under Regulation W, the selling affiliate must be a broker–dealer securities affiliate that is registered with the SEC. Broker–dealers that are registered with the SEC are subject to supervision and examination by the SEC and are required by SEC regulations to keep and maintain detailed records concerning each securities transaction conducted by the broker–dealer. In addition, SEC-registered broker–dealers have experience in determining whether a security has a “ready market” under SEC regulations. The rule does not expand the exemption to include securities purchases from foreign broker–dealers. The rule explicitly provides, however, that a member bank may request that the Board exempt securities purchases from a particular foreign broker–dealer, and the Board would consider these requests on a case-by-case basis in light of all the facts and circumstances.
- *Securities eligible for purchase by a state member bank.* The exemption requires that the bank’s purchase of securities be eligible for purchase by a state member bank. For example, the Board determined that a member bank may purchase equity securities from an affiliate if the member bank’s purchase is made to hedge the bank’s permissible customer-driven equity derivative transaction. The purchase must be treated as a purchase of a security on the bank Call Report.
- *No purchases within 30 days of an underwriting.* The exemption generally prohibits a member bank from using the exemption to purchase securities during an underwriting, or within 30 days of an underwriting, if an affiliate of the bank is an underwriter of the securities. This provision applies unless the security is purchased as part of an issue of obligations of, or obligations fully guaranteed as to principal and interest by, the United States or its agencies. The rule includes the 30-day requirement because of the uncertain and volatile market values of securities during and shortly after an underwriting period and

<sup>79</sup> The rule provides that a U.S. government obligation is an eligible (d)(6) asset only if the obligation’s price is quoted routinely in a widely disseminated publication that is readily available to the general public. Although all U.S. government obligations have low credit risk, not all U.S. government obligations trade in liquid markets at publicly available market quotations.

because of the conflicts of interest that may arise during and after an underwriting period, especially if an affiliate has difficulty selling its allotment.

- *No securities issued by an affiliate.* If a member bank purchases from one affiliate securities issued by another affiliate, it would not exempt the investment in securities issued by the second affiliate, even though the (d)(6) exemption may exempt the asset purchase from the first affiliate. The transaction would be treated as a purchase of, or an investment in, securities issued by an affiliate.
- *Price-verification methods.* The (d)(6) exemption applies only in situations in which the member bank is able to obtain price quotes on the purchased securities from an unaffiliated electronic, real-time pricing service. The Board reaffirms its position that it would not be appropriate to use independent dealer quotations or economic models to establish a market price for a security under the (d)(6) exemption. A security that is not quoted routinely in a widely disseminated news source or a third-party electronic financial network may not trade in a sufficiently liquid market to justify allowing a member bank to purchase unlimited amounts of the security from an affiliate.
- *Record retention.* The rule expressly includes a two-year record-retention and supporting information requirement that is sufficient to enable the appropriate federal banking agencies to ensure that the member bank is in compliance with the terms of the (d)(6) exemption.

*Purchasing municipal securities.* Section 223.42(g) of the rule exempts a member bank's purchase of municipal securities from an affiliate if the purchase meets certain requirements.<sup>80</sup> First, the member bank must purchase the municipal securities from a broker-dealer affiliate that is registered with the SEC. Second, the municipal securities must be eligible for purchase by a state member bank, and the member bank must report the transaction as a securities purchase in its Call Report. Third, the municipal securities must either be rated by a nationally

recognized statistical rating organization (NRSRO) or must be part of an issue of securities that does not exceed \$25 million in size. Finally, the price for the securities purchased must be (1) quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks; (2) verified by reference to two or more actual independent dealer quotes on the securities to be purchased or securities that are comparable to the securities to be purchased; or (3) in the case of securities purchased during the underwriting period, verified by reference to the price indicated in the syndicate manager's written summary of the underwriting.<sup>81</sup> Under any of the three pricing options, the member bank must purchase the municipal securities at or below the quoted or verified price.

*Purchases of assets by newly formed banks.* Section 223.42(i) of the rule exempts a purchase of assets by a newly formed member bank from an affiliate if the appropriate federal banking agency for the bank has approved the purchase. This exemption allows companies to charter a new bank and to transfer assets to the bank free of the quantitative limits and low-quality-asset prohibition of section 23A.

*Transactions approved under the Bank Merger Act.* The Bank Merger Act exemption applies to transactions between a member bank and certain IDI affiliates. Section 223.42(j) exempts transactions between IDIs that are approved pursuant to the Bank Merger Act. The rule also makes the Bank Merger Act exemption available for mergers and other related transactions between a member bank and a U.S. branch or agency of an affiliated foreign bank, if the transaction has been approved by the responsible federal banking agency pursuant to the Bank Merger Act, and should help ensure that such transactions do not pose significant risks to the member bank. There is no regulatory exemption for merger transactions between a national bank and its nonbank affiliate. Any member bank merging or consolidating with a nonbank affiliate may be able to take advantage of the regulatory exemption for internal-reorganization transactions con-

80. Municipal securities are defined by reference to section 3(a)(29) of the Securities Exchange Act. That act defines municipal securities as direct obligations of, or obligations guaranteed as to principal or interest by, a state or agency, instrumentality, or political subdivision thereof, and certain tax-exempt industrial development bonds. (See 17 USC 78c(a)(29).)

81. Under the Municipal Securities Rulemaking Board's Rule G-11, the syndicate manager for a municipal bond underwriting is required to send a written summary to all members of the syndicate. The summary discloses the aggregate par values and prices of bonds sold from the syndicate account.

tained in section 223.41(d) of the rule.

*Purchases of extensions of credit—the purchase exemption.* Regulation W codified, with changes, the exemption that previously was found at 12 CFR 250.250. In general,

- The purchase of an extension of credit on a nonrecourse basis from an affiliate is exempt from section 23A's quantitative limits provided that—
  - the extension of credit is originated by the affiliate,
  - the member bank makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes or commits to make the extension of credit,
  - the member bank commits to purchase the extension of credit before the affiliate makes or commits to the extension of credit, and
  - the member bank does not make a blanket advance commitment to purchase extensions of credit from the affiliate. (See section 223.42(k) of the rule.)

The rule also includes a 50 percent limit on the amount of loans a bank may purchase from an affiliate under the purchase exemption. When a member bank purchases more than half of the extensions of credit originated by an affiliate, the purchases represent the principal ongoing funding mechanism for the affiliate. The member bank's status as the predominant source of financing for the affiliate calls into question the availability of alternative funding sources for the affiliate, places significant pressure on the bank to continue to support the affiliate through asset purchases, and reduces the bank's ability to make independent credit decisions with respect to the asset purchases.

- “*Substantial, ongoing funding*” test. The rule allows the appropriate federal banking agency for a member bank to reduce the 50 percent threshold prospectively, on a case-by-case basis, in those situations in which the agency believes that the bank's asset purchases from an affiliate under the exemption may cause harm to the bank.
- *Independent credit review by the bank.* To qualify for the purchase exemption under section 223.42(k), a member bank must independently review the creditworthiness of the

borrower before committing to purchase each loan. Under established Federal Reserve guidance, a state member bank is required to have clearly defined policies and procedures to ensure that it performs its own due diligence in analyzing the credit and other risks inherent in a proposed transaction.<sup>82</sup> This function is not delegable to any third party, including affiliates of the member bank. Accordingly, to qualify for this exemption, the member bank, independently and using its own credit policies and procedures, must itself review and approve each extension of credit before giving a purchase commitment to its affiliate.

- *Purchase of loans from an affiliate must be without recourse.* In connection with a bank's purchase of loans from an affiliate, the affiliate cannot retain recourse on the loans. The rule (section 223.42(k)) specifies that the exemption does not apply in situations where the affiliate retains recourse on the loans purchased by the member bank. The rule also specifies that the purchase exemption only applies in situations where the member bank purchases loans from an affiliate that were originated by the affiliate. The exemption cannot be used by a member bank to purchase loans from an affiliate that the affiliate purchased from another lender. The exemption is designed to facilitate a member bank's using its affiliate as an origination agent, not to permit a member bank to take off an affiliate's books loans that the affiliate purchased from a third party.

*Intraday extensions of credit.* Section 223.42(l) of the rule provides that intraday credit extensions by a member bank to an affiliate are extensions of credit under section 23A covered transactions but exempts all such intraday credit extensions from the quantitative and collateral requirements of section 23A if the member bank (1) maintains policies and procedures for the management of intraday credit exposure and (2) has no reason to believe that any affiliate receiving intraday credit would have difficulty repaying the credit in accordance with its terms. The establishment of policies and procedures are for—

- monitoring and controlling the credit exposure arising at any one time from the member bank's intraday extensions of credit to each

<sup>82</sup> See, for example, SR-97-21.

affiliate and all affiliates in the aggregate and

- ensuring that any intraday extensions of credit by the member bank to an affiliate comply with the market-terms requirement of section 223.51 of the rule.

*Standard under which the Board may grant additional exemptions.* The Board may grant additional section 23A exemptions requested on a case-by-case basis. All exemption requests from any IDI must be filed with the Board because the Board is the only regulatory agency that can grant an exemption. Section 23A and Regulation W authorize the Board to exempt transactions or relationships by regulation or order if the exemption would be in the public interest and consistent with the purposes of section 23A. Section 223.43 of the rule provides that exemption requests should (1) describe in detail the transaction or relationship for which the member bank seeks exemption, (2) explain why the Board should exempt the transaction or relationship, and (3) explain how the exemption would be in the public's interest and consistent with the purposes of section 23A.

#### *Exemptions and Interpretation from the Attribution Rule of Section 23A*

The attribution rule of section 23A provides that “a transaction by a member bank with any person shall be deemed a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate” (12 USC 371c(a)(2)). One respective interpretation and three exemptions are discussed below.

*Interpretation—Loans to a nonaffiliate that purchases securities or other assets through a depository institution affiliate agent or broker.* In Regulation W, the Board issued an interpretation (12 CFR 223.16(b)) regarding an IDI's loan to a nonaffiliate that purchases assets through an institution's affiliate that is acting as agent. This interpretation confirms that section 23A of the FRA does not apply to extensions of credit an IDI grants to customers that use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution, so long as (1) the affiliate is acting exclusively as an agent or broker in the transaction and (2) the affiliate retains no portion of the

loan proceeds as a fee or commission for its services.

Under this interpretation, the Board concluded that when the affiliated agent or broker retains a portion of the loan proceeds as a fee or commission, the portion of the loan not retained by the affiliate as a fee or commission would still be outside the coverage of section 23A. On the other hand, the portion of the loan retained by the affiliate as a fee or commission would be subject to section 23A because it represents proceeds of a loan by a depository institution to a third party that are transferred to, and used for the benefit of, an affiliate of the institution. The Board, however, granted an exemption from section 23A for that portion of a loan to a third party that an affiliate retains as a market-rate brokerage or agency fee. (See 12 CFR 223.16(c)(2).)

The interpretation would not apply if the securities or other assets purchased by the third-party borrower through the affiliate of the depository institution were issued or underwritten by, or sold from the inventory of, another affiliate of the depository institution. In that case, the proceeds of the loan from the depository institution would be transferred to, and used for the benefit of, the affiliate that issued, underwrote, or sold the assets on a principal basis to the third party.

The above-mentioned transactions are subject to the market-terms requirement of section 23B, which applies to “any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person” (12 USC 371c-1(a)(2)(D)). A market-rate brokerage commission or agency fee refers to a fee or commission that is no greater than that prevailing at the same time for comparable agency transactions the affiliate enters into with persons who are neither affiliates nor borrowers from an affiliated depository institution. (See Regulation W at 12 CFR 223.16(b).)

*Exemption—Loans to a nonaffiliate that purchases securities from a depository institution securities affiliate that acts as a riskless principal.* The Board has granted an exemption in Regulation W from section 23A of the FRA for extensions of credit by an IDI to customers who use the loan proceeds to purchase a security that is issued by a third party via a broker-dealer affiliate of the institution that acts as riskless principal. The exemption for riskless-principal transactions would not apply if the broker-dealer affiliate sold to the third-party borrower

securities that were issued or underwritten by, or sold out of the inventory of, an affiliate of the depository institution. Riskless-principal trades, although the functional equivalent of securities brokerage transactions, involve the purchase of a security by the depository institution's broker-dealer affiliate. Accordingly, the broker-dealer retains the loan proceeds at least for some moment in time.

There is negligible risk that loans a depository institution makes to borrowers to engage in riskless-principal trades through a broker-dealer affiliate of the depository institution would be used to fund the broker-dealer. For this reason, the Board adopted an exemption from section 23A to cover riskless-principal securities transactions engaged in by depository institution borrowers through broker-dealer affiliates of the depository institution. This exemption is applicable even if the broker-dealer retains a portion of the loan proceeds as a market-rate markup for executing the riskless-principal securities trade. (See Regulation W at 12 CFR 223.16(c)(1) and (2).)

*Exemption—Depository institution loan to a nonaffiliate pursuant to a preexisting line of credit and the proceeds are used to purchase securities from the institution's broker-dealer affiliate.* The Board approved an exemption in Regulation W from section 23A for loans by an IDI to a nonaffiliate pursuant to a preexisting line of credit, in which the loan proceeds are used to purchase securities from a broker-dealer affiliate. In more detail, the Board exempted extensions of credit by an IDI to its customers that use the credit to purchase securities from a registered broker-dealer affiliate of the institution, so long as the extension of credit is made pursuant to, and consistent with any conditions imposed in, a preexisting line of credit. This line of credit should not have been established in expectation of a securities purchase from or through an affiliate of the institution. The preexisting requirement is an important safeguard to ensure that the depository institution did not extend credit for the purpose of inducing a borrower to purchase securities from or issued by an affiliate. The preexisting line of credit exemption may not be used in circumstances in which the line has merely been preapproved. (See Regulation W at 12 CFR 223.16(c)(3).)

*Exemption—Credit card transactions.* Regulation W also provides an exemption from section

23A's attribution rule for general-purpose credit card transactions that meet certain criteria. (See section 223.16(c)(4).) The rule defines a general-purpose credit card as a credit card issued by a member bank that is widely accepted by merchants that are not affiliates of the bank (such as a Visa card or Mastercard) if less than 25 percent of the aggregate amount of purchases with the card are purchases from an affiliate of the bank. Extensions of credit to unaffiliated borrowers pursuant to special-purpose credit cards (that is, credit cards that may only be used or are substantially used to buy goods from an affiliate of the member bank) are subject to the rule.

The credit card exemption includes several different methods that are provided for a member bank to demonstrate that its credit card meets the 25 percent test. If a member bank has no commercial affiliates (other than those permitted for a financial holding company (FHC) under section 4 of the BHC Act), the bank would be deemed to satisfy the 25 percent test if the bank has no reason to believe that it would fail the test. (A member bank could use this method of complying with the 25 percent test even if, for example, the bank's FHC controls, under section 4(a)(2), 4(c)(2), or 4(k)(4)(H) of the BHC Act, several companies engaged in nonfinancial activities.) Such a member bank would not be obligated to establish systems to verify strict, ongoing compliance with the 25 percent test. If a member bank has commercial affiliates (beyond those permitted for an FHC under section 4 of the BHC Act), the bank would be deemed to satisfy the 25 percent test if—

- the bank establishes systems to verify compliance with the 25 percent test on an ongoing basis and periodically validates its compliance with the test or
- the bank presents information to the Board demonstrating that its card would comply with the 25 percent test. (One way that a member bank could demonstrate that its card would comply with the 25 percent test would be to show that the total sales of the bank's affiliates are less than 25 percent of the total purchases by cardholders.)

Second, for those member banks that fall out of compliance with the 25 percent test, there is a three-month grace period to return to compliance before extensions of credit under the card

become covered transactions. Third, member banks that are required to validate that their ongoing compliance with the 25 percent test have a fixed method, time frames, and examples for computing compliance.

*Example of calculating compliance with the 25 percent test.* A member bank seeks to qualify a credit card as a general-purpose credit card under section 223.16, paragraph (c)(4)(ii)(A), of the rule. The member bank assesses its compliance under paragraph (c)(4)(iii) of this section on the 15th day of every month (for the preceding 12 calendar months). The credit card qualifies as a general-purpose credit card for at least three consecutive months. On June 15, 2005, however, the member bank determines that, for the 12-calendar-month period from June 1, 2004, through May 31, 2005, 27 percent of the total value of products and services purchased with the card by all cardholders were purchases of products and services from an affiliate of the member bank. Unless the credit card returns to compliance with the 25 percent limit by the 12-calendar-month period ending August 31, 2005, the card will cease to qualify as a general-purpose credit card as of September 1, 2005. Any outstanding extensions of credit under the credit card that were used to purchase products or services from an affiliate of the member bank would become covered transactions at such time.

## SECTION 23B OF THE FEDERAL RESERVE ACT

Section 23B of the FRA became law on August 10, 1987, as part of the Competitive Equality Banking Act of 1987. This section also regulates transactions with affiliates. Section 23B applies to any covered transactions with an affiliate but excludes banks from the term “affiliate” as that term is defined in section 23A.

Regulation W, subpart F, sets forth the principal restrictions of section 23B. These include (1) a requirement that most transactions between a member bank and its affiliates be on terms and circumstances that are substantially the same as those prevailing at the time for comparable transactions with nonaffiliates; (2) a restriction on a member bank’s purchase as fiduciary of assets from an affiliate unless certain criteria are met; (3) a restriction on a member bank’s

purchase, during the existence of an underwriting syndicate, of any security if a principal underwriter of the security is an affiliate; and (4) a prohibition on publishing an advertisement or entering into an agreement stating that a member bank will be responsible for the obligations of its affiliates. For the most part, subpart F restates the operative provisions of section 23B. The following transactions with affiliates are covered by section 23B:

- any covered transaction with an affiliate
- the sale of securities or other assets to an affiliate, including assets subject to repurchase
- the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise
- any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person
- any transaction or series of transactions with a nonaffiliate if an affiliate—
  - has a financial interest in the third party or
  - is a participant in the transaction or series of transactions

Any transaction by a member bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate. A member bank and its subsidiaries may engage in the transactions covered by section 23B of the FRA only on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with, or that in good faith would be offered to, nonaffiliate companies.

Section 23B restricts the following transactions with affiliates:

- A member bank or its subsidiary cannot purchase as fiduciary any securities or other assets from any affiliate unless the purchase is permitted—
  - under the terms of the instrument creating the fiduciary relationship,
  - by court order, or
  - by the law of the jurisdiction governing the fiduciary relationship.
- A member bank or its subsidiary, whether acting as principal or fiduciary, cannot knowingly purchase or acquire, during the existence of any underwriting or selling syndicate,



any security if a principal underwriter of that security is an affiliate of the bank. This limitation applies unless the purchase or acquisition of the security has been approved before it is initially offered for sale to the public by a majority of the directors of the bank. The purchase should be based on a determination that it is a sound investment for the bank irrespective of the fact that an affiliate of the bank is a principal underwriter of the securities.

## Transactions Exempt from Section 23B of the Federal Reserve Act

The market-terms requirement of section 23B applies to, among other transactions, any “covered transaction” between a member bank and an affiliate.<sup>83</sup> Section 23B(d)(3) makes clear that the term “covered transaction” in section 23B has the same meaning as the term “covered transaction” in section 23A but does not include any transaction that is exempt under section 23A(d)—for example, transactions between sister banks,<sup>84</sup> transactions fully secured by a deposit account or U.S. government obligations, and purchases of assets from an affiliate at a readily identifiable and publicly available market quotation.<sup>85</sup> Consistent with the statute, Regulation W’s section 223.52(a)(1) exempts from section 23B any transaction that is exempt under section 23A(d).<sup>86</sup>

The rule also excludes from section 23B any covered transaction that is exempt from section 23A under section 223.42(i) or (j) (that is, asset purchases by a newly formed member bank and transactions approved under the Bank Merger Act). The Board excluded from section 23B this additional set of transactions because, in each case, the appropriate federal banking agency for the member bank involved in the transaction should ensure that the terms of the transaction are not unfavorable to the bank.

## Purchases of Securities for Which an Affiliate Is the Principal Underwriter

The GLB Act amended section 23B to permit a member bank to purchase securities during an underwriting conducted by an affiliate if the following two conditions are met. First, a majority of the directors of the member bank (with no distinction drawn between inside and outside directors) must approve the securities purchase before the securities are initially offered to the public. Second, such approval must be based on a determination that the purchase would be a sound investment for the member bank regardless of the fact that an affiliate of the bank is a principal underwriter of the securities.<sup>87</sup> Section 223.53(b) includes this standard and clarifies that if a member bank proposes to make such a securities purchase in a fiduciary capacity, then the directors of the bank must base their approval on a determination that the purchase is a sound investment for the person on whose behalf the bank is acting as fiduciary.

A member bank may satisfy this director-approval requirement by obtaining specific prior director approval of each securities acquisition otherwise prohibited by section 23B(b)(1)(B). The rule clarifies, however, that a member bank also satisfies this director-approval requirement if a majority of the directors of the bank approves appropriate standards for the bank’s acquisition of securities otherwise prohibited by section 23B(b)(1)(B), and each such acquisition meets the standards adopted by the directors. In addition, a majority of the member bank’s directors must periodically review such acquisitions to ensure that they meet the standards and must periodically review the standards to ensure they meet the “sound investment” criterion of section 23B(b)(2). The appropriate period of time between reviews would vary depending on the scope and nature of the member bank’s program, but such reviews should be conducted by the directors at least annually. Before the passage of the GLB Act, Board staff informally allowed member banks, based on the legislative history of section 23B, to meet the director-approval requirement in this fashion, and there

83. 12 USC 371c-1(a)(2)(A).

84. Although transactions between banks are exempt from section 23B, the safety-and-soundness provisions of section 23A apply and generally require that transactions be conducted on terms similar to those terms and standards outlined in section 23B.

85. 12 USC 371c-1(d)(3).

86. Regulation W will again be subsequently referred to as the “rule” or by its specified section-numbered discussion of section 23B provisions.

87. 12 USC 371c-1(b)(2). The rule provides that a U.S. government obligation is an eligible (d)(6) asset only if the obligation’s price is quoted routinely in a widely disseminated publication that is readily available to the general public. Although all U.S. government obligations have low credit risk, not all U.S. government obligations trade in liquid markets at publicly available market quotations.

is no indication that Congress in the GLB Act intended to alter the procedures that a member bank could use to obtain the requisite director approval.<sup>88</sup> The rule codifies staff's preexisting approach to the director-approval requirement.<sup>89</sup>

## Definition of Affiliate Under Section 23B

Section 23B states that the term "affiliate" under section 23B has the meaning given to such term in section 23A except that the term

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88. The conference report accompanying the Competitive Equality Banking Act of 1987 stated that the prior-approval requirement of section 23B(b) could be met "by the establishment in advance of specific standards by the outside directors for such acquisitions. If the outside directors establish such standards, they must regularly review acquisitions to assure that the standards have been followed, and they must periodically review the standards to assure that they continue to be appropriate in light of market and other conditions." See H.R. Conf. Rep. No. 100-261 at 133 (1987).

89. The rule also provides, consistent with existing Board interpretations, that a U.S. branch, agency, or commercial lending company of a foreign bank may comply with this requirement by obtaining the required approvals and reviews from either a majority of the directors or a majority of the senior executive officers of the foreign bank.

"affiliate" under section 23B does not include a "bank," as defined in section 23A.<sup>90</sup> In the case of the sister-bank exemption, the rule's section 223.2(c) clarifies that the only companies that qualify for the "bank" exception to section 23B's definition of affiliate are insured depository institutions.

## Advertising and Guarantee Restriction

In section 23B(c), the "advertising restriction" prohibits a member bank from publishing any advertisement or entering into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates. Regulation W clarifies this restriction to permit such guarantees and similar transactions if the transaction satisfies the quantitative and collateral restrictions of section 23A.<sup>91</sup> The rule also clarifies that section 23B(c) does not prohibit a member bank from making reference to such a guarantee, acceptance, or letter of credit in a prospectus or other disclosure document, for example, if otherwise required by law.

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90. 12 USC 371c-1(d)(1).

91. 12 USC 371c-1(c).

# Transactions Between Member Banks and Their Affiliates

## Examination Objectives

Effective date May 2001

Section 4050.2

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1. To determine compliance with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.
2. To determine the relationships between the bank and its affiliates and the effects of those relationships and their transactions on the operations and safety and soundness of the bank.
3. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Transactions Between Member Banks and Their Affiliates Examination Procedures

Effective date November 2003

## Section 4050.3

1. *Section 23A of the Federal Reserve Act (12 USC 371c), Relations with Affiliates, and the Board's Regulation W.* By coordinating work with the examiners assigned to the various loan areas, determine compliance with laws and regulations pertaining to related organizations by performing the following procedures.
  - a. Obtain a listing of loans to affiliates.
  - b. Compare the listing with the bank's customer liability records to determine the list's accuracy and completeness.
  - c. Obtain a listing of other covered transactions with affiliates (that is, for example, purchase of securities issued by an affiliate, purchase of assets, acceptance of securities issued by an affiliate as collateral for a loan to any person or company, or the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate).
  - d. Conduct transaction testing of intercompany affiliate transactions<sup>1</sup> for compliance with the limitations of section 23A of the Federal Reserve Act and the Board's Regulation W (see SR-03-02) by—
    - reviewing—
      - the time elapsed between the original issuance of the affiliate's debt securities and the bank's purchase,
      - the existence of any relevant agreements or relationships between the bank and the third-party seller of the affiliate's debt securities,
      - any history of bank financing of the affiliate, and
      - any other relevant information;
    - documenting any violations or potential violations, and reaching an agreement with the directors and senior management to resolve violations quickly; and
    - considering the inclusion of defaulted country risk problem assets in the evaluation of asset quality and capital adequacy. (See section 7040.1.)
  - e. Ensure that transactions with affiliates meet the collateral requirements of section 23A.
  - f. Ensure that low-quality loans have not been purchased from an affiliate.
  - g. Determine that all transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
  - h. *Policies and procedures.*
    - Obtain the bank's policies and procedures to determine compliance with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.
    - Ensure the policies and procedures cover all relevant affiliates (e.g., financial subsidiaries and joint ventures) and transactions covered by section 23A, and verify that the bank treats "sponsored and advised" companies as affiliates ("Sponsored and advised" companies would include, at a minimum, any company that receives investment advice and administrative services on a contractual basis from a member bank, whose trustees or managers are selected by the bank, and that has a name similar to that of the bank.).
    - Ensure that the policies and procedures are comprehensive and include adequate controls—
      - to identify covered transactions and
      - to ensure that necessary steps are performed for identified transactions (e.g., the required collateralization of loans to affiliates).
  - i. *Covered transactions.*
    - If the controls for section 23A are considered adequate, use the list of covered transactions provided by the bank.
    - If controls are considered inadequate (for example, for transactions testing), review the bank's general ledger to identify transactions that are covered transactions.
    - Verify that covered transactions count against required limits and are collateralized when required.
    - If the bank uses an internal rating sys-

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1. Examples of affiliates include a bank holding company and its nonbank subsidiaries, companies under the member bank's control (see Regulation W, section 223.3(g)), any mutual fund advised by a member bank, merchant banking investments, a member bank or affiliate serving as a general partner in a partnership, and affiliates' subsidiaries. In addition, certain joint venture companies, ESOPs of banks and their affiliates, and special-purpose entities are affiliates if the regulatory definitions of control are met.

- tem for its assets, determine that the bank has not deferred or altered an asset's rating to facilitate sale of the asset to an affiliate.
- Review controls for monitoring compliance with the established limits and for collateralizing required credit-extension transactions.
  - If controls are considered inadequate (for example, for transactions testing), ensure that covered transactions are properly valued.
  - Verify that identified covered transactions comply with the limits of sections 23A and 23B (If the covered transactions do not comply with the limits, criticize the bank for inadequate controls, and discuss what steps the bank will use to correct the violations.).
  - Obtain collateral listings, and verify that necessary covered transactions are adequately collateralized:
    - Verify that the values of omnibus deposit accounts used to secure covered transactions are sufficient to fully secure the relevant covered transactions.
    - Review collateral documentation to ensure that the bank's interest is adequately perfected and prioritized (Regulation W, section 223.14(d)).
- j. *Corporate lending (funding)*. Ensure that there is compliance with the collateral requirements and quantitative limits:
- Obtain the bank's "trial balances" of loans.
  - Check that loans to affiliates are included on the list of "covered transactions" and included in measurements for compliance with the quantitative limits. If some loans are not included, ascertain why.
  - If an exemption is being used, verify that its application is correct.
  - Verify that the loans are collateralized (using collateral listings), and review the documentation to ensure proper collateralization.
- k. *Verification of exemptions*.
- For renewal of participations involving problem loans (see Regulation W, section 223.15(b)) involving nondepository affiliates, review supporting documentation to ensure that—
    - the loan was not low quality at the time the bank purchased the participation,
    - the renewal is approved at the board committee or senior management level as appropriate, and
    - the bank's share of the renewal does not exceed its original share by more than 5 percent (unless approved by an appropriate federal bank regulator) and that the bank notified the federal bank regulator within 20 days.
  - For retail lending (e.g., credit cards and mortgage banking) involving the funding of loans and the purchase of loans, ensure compliance with quantitative limits (for funding and compliance with collateral requirements) as follows:
    - For credit card examinations, obtain the "trial balances" of the outstanding balances, and for mortgage banking, obtain lists of the loans sold.
    - Check that credit card amounts generated by bank affiliates and mortgage loans sold to the bank by affiliates are included on the list of covered transactions and in measurements for compliance with the quantitative limits. If they are not included, ascertain why.
    - If an exemption is being used, verify that its use is correct.
    - Verify that loans are collateralized (using collateral), and review the documentation to ensure proper collateralization.
  - For the general-purpose credit card exemption (Regulation W, section 223.16(c)(4)), verify, through review of relevant documentation, that the bank can demonstrate that its credit card meets the less than 25 percent test through one of three available methods. (An exemption from the attribution rule for extensions of credit under a general-purpose credit card is defined as one on which "less than 25 percent of the aggregate amount of purchases are purchases from a bank affiliate.")
    - The bank has no commercial affiliates.
    - The bank establishes systems to verify compliance with the less than 25 percent test on an ongoing basis.

- The bank presents information to the Board of Governors to demonstrate its card would comply.
  - For purchases of extensions of credit—the “250.250 exemption” (Regulation W, section 223.42(k))—review supporting documentation to ensure that—
    - the member bank makes an independent creditworthiness evaluation before the affiliate makes or commits to make the loan,
    - the bank commits to make the loan purchase before the affiliate makes the loan,
    - the bank does not make a blanket advance commitment to purchase loans, and
    - the purchases from the affiliate by the depository institution and all depository institution affiliates in the prior 12 months represent 50 percent or less of all loans originated by the affiliate during such period.
  - l. If the bank is critically undercapitalized (under prompt-corrective-action rules), determine if the bank has engaged in any covered transaction, as defined in section 23A, without the prior approval of the FDIC or FRS.
  - m. *Internal controls.*
    - Determine the bank’s methods for identifying transactions subject to sections 23A and 23B of the Federal Reserve Act. Determine if these methods adequately identify such transactions. Consider the following information:
      - internal reports (Management should document any covered transactions with affiliates.)
      - loan records
      - deposit accounts
      - accounts payable and receivable
      - board minutes
    - Determine if management understands what services its affiliates provide.
    - Determine the volume and frequency of inter-institution transactions, such as loan participations or sales, purchases or sales of other assets, bank stock loans, insider transactions, and contractual obligations for services. Review these transactions for possible noncompliance or abusive practices.
    - Review any formal or informal agreements regarding covered transactions.
  - Determine if management adequately documents the cost, fee structure, and quality of services.
    - Determine the bank’s compliance with any outstanding conditions of an approved order or commitment issued by the regulator.
  - n. Determine if the affiliates are in compliance with the capital requirements of their functional regulator.
  - o. If the bank has used the expanded (d)(4) exemption, determine that the bank regularly reviews the market value of its U.S. government obligations collateral.
  - p. Determine that the bank’s program for monitoring and controlling the credit exposure from derivative transactions with affiliates includes, at a minimum, imposing appropriate credit limits, mark-to market or fair value requirements, and collateral requirements.
  - q. Determine that the limits and requirements reflect the nature, volume, and complexity of the bank’s derivatives transactions.
  - r. Determine that the limits and requirements on credit exposures from derivative transactions have been approved by the board of directors of the bank or an appropriate board committee.
  - s. Determine that the bank’s program for monitoring and controlling the credit exposure from intraday extensions of credit to affiliates includes, at a minimum, imposing appropriate credit limits (on a per-affiliate and aggregate basis) and collateral requirements.
  - t. Determine that the limits and requirements imposed by the bank reflect the volume of intraday credit transactions and the reasons for those transactions.
  - u. Determine that the limits and requirements on intraday credit transactions have been approved by the board of directors of the bank or an appropriate board committee.
2. *Section 23B of the Federal Reserve Act (12 USC 371c-1), Restrictions on Transactions with Affiliates, and the Board’s Regulation W.*
  - a. Determine that covered transactions with affiliates comply with the restrictions in section 23B.
  - b. If the bank has derivative transactions with affiliates, determine that the bank has

- treated the affiliate no better than a similarly situated nonaffiliate.
- c. Determine that management and other fees paid by the bank have a direct relationship to the value of the actual goods and services rendered, based on reasonable costs consistent with current market values for such goods and services.
- d. Review any mortgage banking activity and servicing contracts with affiliates, if applicable. Give particular attention to—
- the capacity in which the affiliate is acting,
  - the nature of the services provided,
  - the billing arrangement, frequency of billing, method of computation, and the basis for fees,
  - the method of compensating the bank for balances maintained and net interest earned on warehouse loans and lines of credit (This method should not be preferential.),
  - the pricing of loan and servicing-right sales,
  - advertising restrictions (for noncompliance).

The examination of bank-related organizations must be of sufficient scope to determine a bank's compliance with laws and to evaluate its investments through an appraisal of related organizations' assets, earnings, management, and operations. In addition, the examination must fully disclose the nature of the relationships between the bank and its related organizations, as well as the effects of these relationships on the operations and safety and soundness of the bank.

### FORMS OF RELATED ORGANIZATIONS

Various laws, rulings, and regulations have encouraged banks to expand their services by forming or acquiring related organizations. Examples include when

- a member bank is permitted to purchase for its own account shares of a corporation that performs, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly;
- authorization is provided by specific laws to invest in various statutory subsidiaries; and
- permission is provided by Federal Reserve regulations to invest in Edge Act and agreement corporations.

In addition, a bank also may be controlled by an individual or company that controls other bank or nonbank entities. Regardless of the legal organizational structure between a bank and a related organization, a sound financial and satisfactory management relationship between both groups is essential to the bank's operation. Related organizations may assume several forms, as described in this section.

### Affiliates

Affiliates are defined in subsection (b)(1) of section 23A of the Federal Reserve Act (FRA).<sup>1</sup> Generally an affiliate is a company that is under common control with the bank. In addition, section 23A specifically states that certain enti-

ties are not considered affiliates of a member bank. See section 4050.1 regarding the detailed provisions of section 23A and section 23B of the FRA, and Regulation W.

### Operations Subsidiaries

The Board has authorized member banks to establish and own operations subsidiaries. "Operations subsidiaries" are organizations that are, in effect, designed to serve as separately incorporated departments of a bank.

#### *Member Bank Purchases of Stock of Operations Subsidiaries*

The Board concluded in 1968 that ". . . a member bank may purchase for its own account shares of a corporation to perform, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly" (12 CFR 250.141(i)). The Board reasoned that this authority could reasonably be interpreted as within a bank's incidental powers to "organize its operations in the manner that it believes best facilitates the performance thereof," and that the subsidiary essentially constitutes a separately incorporated division or department of the bank.

No specific rule requires a state member bank to give the Board prior notice of, or to acquire the Board's approval for, the acquisition of an operations subsidiary to engage in activities that the bank itself may lawfully perform. However, section 208.3(d)(2) of Regulation H (12 CFR 208.3(d)(2)) prohibits a state member bank from causing or permitting a change in the general character of its business or in the scope of its corporate powers approved at the time of admission to membership, except with the permission of the Board.

#### *Transactions between a State Member Bank and Its Operations Subsidiary*

The Board noted in 1970 that "since an operations subsidiary is in effect a part of, and subject to the same restrictions as, its parent bank, there is no reason to limit transactions between the bank and such subsidiary any more than trans-

1. See 12 USC 371c.



actions between departments of a bank.” The Board concluded that “a credit transaction by a state member bank with its operations subsidiary . . . is not a ‘loan or . . . extension of credit’ of the kind intended to be restricted and regulated by section 23A and is, therefore, outside the purview of that section” (12 CFR 223.2(b)(1)–(2)).

## Operations Subsidiary Not Wholly Owned

The previously mentioned 1968 interpretation only expressly authorized state member banks to establish wholly owned operations subsidiaries in that a wholly owned subsidiary of a bank is functionally indistinguishable from a division or department of the bank. In enacting the Gramm-Leach-Bliley Act (GLB Act), Congress recognized the authority of national and state member banks to own and control an operations subsidiary. The GLB Act recognized traditional operations subsidiaries by distinguishing them from financial subsidiaries. The definition of financial subsidiary excludes a company engaged solely in activities that a parent bank may perform, subject to the limitations that govern the conduct of these activities.

The GLB Act also does not appear to require that a state member bank own 100 percent of an operations subsidiary or a financial subsidiary. The GLB Act defines the term “subsidiary” by reference to the Bank Holding Company (BHC) Act. Under the BHC Act, a company is a “subsidiary” of a bank holding company if the BHC (1) owns or controls 25 percent or more of the company’s voting shares or (2) controls the election of a majority of the company’s directors.<sup>2</sup>

The Board thus believes that, as a result of the GLB Act and consistent with section 5136 of the Revised Statutes (12 USC 24 (Seventh)) and the Board’s 1968 interpretation, a state member bank may acquire shares of a company that is not wholly owned and that (1) on consummation of the acquisition would be a subsidiary of the bank within the meaning of the BHC Act, and (2) engages only in activities in which the parent

bank may engage, at locations at which the bank may engage in the activities, subject to the same limitations as if the bank were engaging in the activities directly.

## FINANCIAL SUBSIDIARIES

Qualifying state member banks may control or hold an interest in a “financial subsidiary.” A financial subsidiary is any company that is controlled by one or more insured depository institutions and engages in activities that are financial in nature or incidental to a financial activity. A financial subsidiary does not include (1) a subsidiary that the state member bank is specifically authorized to hold by the express terms of federal law (other than by section 9 of the FRA), such as an Edge Act subsidiary held under section 25 of the FRA, or (2) a subsidiary that engages only in activities that the parent bank could conduct directly and that are conducted on the same terms and conditions that govern the conduct of the activity by the state member bank. Financial subsidiaries are authorized for national banks by section 5136A of the Revised Statutes (12 USC 24a) and for state banks by section 46 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1831w). To implement the authorization for state member banks, a new subpart G was added to Regulation H (12 CFR 208.71 et seq.).

## Investing in or Controlling a Financial Subsidiary

Under the GLB Act, a state member bank may control, or hold an interest in, a financial subsidiary only if

- the state member bank and each of its depository institution affiliates are well capitalized and well managed;<sup>3</sup>
- the aggregate consolidated total assets of all the bank’s financial subsidiaries do not exceed

3. An institution is “well capitalized” if it meets or exceeds the capital levels designated by the institution’s appropriate federal banking agency (section 38 of the FDI Act (12 USC 1831o)). A depository institution will be deemed “well managed” by references to specific examination ratings, or if the depository institution has not been examined by its federal or state banking agency and its federal banking agency determines that the existence and use of managerial resources are satisfactory (see 12 CFR 208.77(h)(ii)).

2. See 12 USC 1841(d). A company also is considered a subsidiary of a bank holding company if the Board determines, after notice and opportunity for a hearing, that the bank holding company directly or indirectly exercises a controlling influence over the management or policies of the company.

- the lesser of 45 percent of the consolidated total assets of the bank or \$50 billion;<sup>4</sup>
- the state member bank is one of the 100 largest insured banks and meets the following debt-rating or alternative debt-rating requirements:
    - for the 50 largest insured banks, the bank must have at least one issue of outstanding eligible debt that is currently rated in one of the three highest investment-grade rating categories by a nationally recognized statistical rating organization;<sup>5</sup>
    - for the next 50 largest insured banks, the bank must meet the issuer-credit-rating requirement for the 50 largest insured banks or the bank must meet the alternative criteria established jointly by regulation by the Secretary of the Treasury and the Federal Reserve<sup>6</sup> (the debt-rating and alternative criteria are not applicable if the bank's financial subsidiaries engage in any newly authorized financial activities solely as agent and not as principal); and
  - the state member bank obtains the Federal Reserve's approval to engage in the activities of the financial subsidiary (using the notice procedures in section 208.76 of Regulation H). The state member bank also must obtain any necessary approvals from its state supervisory authority.

### *Issuer-Credit-Rating Requirement*

The issuer-credit-rating requirement of Regulation H (12 CFR 208.71) requires a long-term issuer credit rating from a nationally recognized statistical rating organization that is within the three highest investment-grade rating categories used by the organization. An "issuer credit rating" is one that assesses the bank's overall capacity and willingness to pay, on a timely basis, its unsecured financial obligations. An

issuer credit rating differs from a debt rating in that it does not assess the bank's ability or willingness to make payments on any individual class or issue of debt, nor does it reflect payment priority or payment preferences among financial obligations.

Under Regulation H, the issuer credit rating must be assigned to the national or state member bank that controls or holds an interest in a financial subsidiary. Issuer credit ratings that are assigned to a subsidiary or affiliate of the parent bank, such as a subsidiary engaged in derivatives activities, do not meet the regulation's requirements. Rating organizations may issue long-term or short-term issuer credit ratings for the same bank and separate ratings for dollar-denominated and foreign-currency-denominated obligations. Only long-term issuer ratings for dollar-denominated obligations satisfy the requirements of the regulation. A "long-term credit rating" is a written opinion that is issued by a nationally recognized statistical rating organization regarding the bank's overall capacity and willingness to pay on a timely basis its unsecured, dollar-denominated financial obligations maturing in no less than one year.

The Secretary of the Treasury and the Federal Reserve have determined that certain types of ratings assigned by the rating agencies (see Table 1) currently meet the requirements of Regulation H, provided that the ratings assess the parent bank's ability and willingness to meet its financial obligations denominated in U.S. dollars.

Standard and Poor's may modify its AA or A ratings to include a plus (+) or minus (-) sign to show relative standing within these rating categories. Any rating from A minus to AAA would satisfy the long-term issuer-credit-rating requirement; an A minus would constitute the lowest acceptable rating in the case of Standard & Poor's and Fitch. Moody's top three investment-grade categories for long-term issuer credit ratings are Aaa, Aa, or A, with Aaa denoting the highest rating. Moody's applies numerical modifiers of 1, 2, and 3 in the Aa and A rating categories, with 3 denoting the lowest end of the letter-rating modifiers. Any rating from A-3 to Aaa would satisfy the long-term issuer-credit-rating requirement; a rating of A-3 would be the lowest acceptable rating in the case of Moody's.

4. This dollar amount will be adjusted based on an indexing mechanism that is established jointly by the Federal Reserve Board and the Secretary of the Treasury.

5. "Eligible debt" refers to unsecured debt that has an initial maturity of more than 360 days. The debt must be issued and outstanding, may not be supported by any form of credit enhancement, and may not be held in whole or any significant part by affiliates or insiders of the bank or by any other person acting on behalf of or with funds from the bank or an affiliate.

6. The size of an insured bank is determined based on the consolidated total assets of the bank as of the end of each calendar year.

Table 1—Acceptable Rating Organizations and Ratings

<i>Rating Organization</i>	<i>Type of Rating</i>	<i>Rating</i>
Standard & Poor's	Issuer credit rating (including a counterparty credit rating)	AAA, AA, or A
Moody's	Issuer credit rating	Aaa, Aa, or A
Fitch	International credit rating	AAA, AA, or A

## Prudential Standards

A state member bank that owns a financial subsidiary must comply with certain prudential safeguards. These standards pertain to the bank's capital requirements and its establishment of policies and procedures arising from financial subsidiary ownership.

As for the capital requirements, the state member bank must “deconsolidate” the assets and liabilities of all of its financial subsidiaries from those of the bank. Although the GLB Act requires a bank to deconsolidate the assets and liabilities of any financial subsidiary for regulatory capital purposes, a financial subsidiary remains a subsidiary of a state member bank. The Board will continue to review the operations and financial and managerial resources of the bank on a consolidated basis as part of the supervisory process. The Board may take appropriate supervisory action if it believes that the bank does not have the appropriate financial and managerial resources (including capital resources and risk-management controls) to conduct its direct or indirect activities in a safe and sound manner.

In addition to the deconsolidation described above, the bank must also deduct a specified percentage of the aggregate amount of the equity investment (including retained earnings) (“the aggregate amount”) in all financial subsidiaries from the bank's capital and assets. Therefore, the bank must deduct

- 50 percent of the aggregate amount from both the bank's tier 1 capital and its tier 2 capital for purposes of determining its risk-based capital ratios;
- 50 percent of the aggregate amount from the bank's tier 1 capital for purposes of determining its leverage ratios; and
- 100 percent of the aggregate amount from its

tangible equity for purposes of determining its tangible equity capital ratio. It must also deduct 100 percent of the aggregate amount from the bank's risk-weighted assets, average total assets, and total assets when determining its risk-based, leverage, and tangible capital ratios.

The bank must meet all capital requirements—including the “well-capitalized” requirement (Regulation H, section 208.71) and the capital levels established by the Board under section 38 of the FDI Act—after the adjustments described above.

The member bank must also establish and maintain policies and procedures to manage the financial and operational risks associated with its ownership of a financial subsidiary. These procedures must identify and manage financial and operational risks with the bank and its financial subsidiaries. They must adequately protect the bank from such risks and preserve the bank's separate corporate identity and the limited liability of the bank and its financial subsidiaries. In addition, a financial subsidiary of a state member bank is considered a non-subsidiary affiliate of the bank for purposes of sections 23A and 23B of the FRA and a subsidiary of the BHC (and not a subsidiary of a bank) for the purposes of the anti-tying prohibitions of the BHC Act Amendments of 1970.

## Permissible Activities for a Financial Subsidiary

A financial subsidiary can engage in three types of permissible activities:

1. Those activities that are determined to be financial in nature or incidental to financial activities under section 4(k)(4) of the BHC

Act. These permissible activities include

- general insurance agency activities in any location and travel agency activities;
  - underwriting, dealing in, and making a market in all types of securities; and
  - any activity that the Federal Reserve determined by regulation or order to be closely related to banking or managing or controlling banks so as to be a proper incident thereto and that was in effect on the effective date of the GLB Act. (See section 225.86 of the Board's Regulation Y (12 CFR 225.86).)
2. Activities that the Secretary of the Treasury, in consultation with the Board, determines to be financial in nature or incidental to financial activities and permissible for financial subsidiaries of national banks pursuant to section 5136A(b) of the Revised Statutes of the United States (12 USC 24a(b)).
  3. Activities that the state member bank is permitted to engage in directly under state law, subject to the same terms and conditions that govern the conduct of the activity by the state member bank (12 USC 24a(a)(2)(A)(ii)).

### Impermissible Activities for a Financial Subsidiary

A financial subsidiary may not engage in the following activities: (1) as principal in insurance underwriting (except to the extent permitted for national banks by the Comptroller of the Currency as of January 1, 1999, and not subsequently overturned in certain grandfathered title insurance activities); (2) providing or issuing annuities; (3) real estate investment or development (except as expressly authorized by law); and (4) merchant banking and insurance company investment activities.

### Federal Reserve Approval Requirements

Federal Reserve approval of a financial subsidiary involves a streamlined notice procedure. A state member bank must file a notice with the appropriate Reserve Bank before acquiring control of, or an interest in, a financial subsidiary, or before engaging in an additional financial activ-

ity through an existing financial subsidiary. No notice is required for a financial subsidiary to engage in an additional activity that the parent state member bank could conduct directly. The notice must include basic information on the financial subsidiary and its existing and proposed activities. In the case of an acquisition, the notice should include a description of the transaction through which the bank proposes to acquire control of, or an interest in, the financial subsidiary. The notice also must contain a certification that the state member bank and its depository institution affiliates meet the capital, management, and credit-rating requirements to own a financial subsidiary, as stated in the GLB Act and subpart G of Regulation H. If the notice is for the state member bank's initial affiliation with a company engaged in insurance activities, the notice must describe the company's insurance activities and identify the states where the company holds an insurance license. A notice will be considered approved on the 15th day after receipt of a complete notice by the appropriate Reserve Bank, unless before that date, the notice is approved or denied or the bank is notified that additional time is needed to review the submitted notice.

The GLB Act permits a state member bank to acquire an interest in or control a financial subsidiary if the bank meets the criteria and requirements set forth in Regulation H. The Board, however, retains its general supervisory authority for state member banks and may restrict or limit the activities of, or the acquisition or ownership of a subsidiary by, a state member bank if the Board finds that the bank does not have the appropriate financial and managerial resources to conduct the activities or to acquire or retain ownership of the company.

### AGRICULTURAL CREDIT CORPORATIONS

The increasing number of agricultural credit corporations and their effect on parent banks have intensified the need for their supervision. Most agricultural credit corporations are under the direct supervision of the district Federal Intermediate Credit Bank (FICB) where the corporations discount most of their loans. However, an agricultural credit corporation may obtain funds exclusively in the open market and avoid FICB regulation.

## EDGE ACT AND AGREEMENT CORPORATIONS

U.S.-based corporations and permissible activities for their Edge Act and agreement corporation subsidiaries are described in detail in the Board's Regulation K (12 CFR 211). Edge Act and agreement corporations provide banks with a vehicle for engaging in international banking or foreign financial operations. They also have the power, with supervisory consent, to purchase and hold the stock of foreign banks and other international financial concerns. Edge Act and agreement corporations are examined by the Federal Reserve, and their respective reports of examination should be reviewed during each examination of a parent member bank. The examiner should review the Federal Reserve examination report and also the amount and quality of negotiable instruments (e.g., commercial paper) held when evaluating the bank's investment in the Edge corporation.

Transactions between the parent bank and the bank's Edge Act and agreement corporation subsidiaries are not subject to the limitations in section 23A. However, they are subject to limitations under section 25 of the FRA (12 USC 601) and under the Board's Regulation K. In addition, transactions with such bank subsidiaries and the parent bank's affiliates are aggregated with transactions by the bank and its affiliates for purposes of section 23A limitations and restrictions. Transactions between a bank and Edge Act and agreement corporation subsidiaries of the bank's holding company are also subject to section 23A.

## FOREIGN BANKING ORGANIZATIONS

Under section 211.21(o) of Regulation K (12 CFR 211.21(o)), the term foreign banking organization includes

- a foreign bank, as defined in section 1(b)(7) of the International Banking Act (12 USC 3101(7)) that
  - operates a branch, agency, or commercial lending company subsidiary in the United States;
  - controls a bank in the United States; or
  - controls an Edge corporation acquired after

March 5, 1987; and any company of which the foreign bank is a subsidiary.

On March 15, 2006, the Board approved a revision to Regulation K (effective April 19, 2006), incorporating the provisions of section 208.63 of Regulation H by reference into sections 211.5 and 211.24 of Regulation K. Edge and agreement corporations and other foreign banking organizations (that is, U.S. branches, agencies, and representative offices of foreign banks that are supervised by the Federal Reserve) must establish and maintain procedures reasonably designed to ensure and monitor compliance with the Bank Secrecy Act and related regulations. Each of these banking organizations' compliance programs must include, at a minimum, (1) a system of internal controls to ensure ongoing compliance, (2) independent testing of compliance by the institution's personnel or by an outside party, (3) the designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance, and (4) training for appropriate personnel. (See SR-06-7.)

## FOREIGN BANKS

A *foreign bank* is an organization that is

- organized under the laws of a foreign country and
- engages directly in the business of banking outside the United States.

## FOREIGN BANK OFFICES

A *foreign bank office* consists of any branch, agency, representative office, or commercial lending company subsidiary of a foreign bank operating in the United States.

## Branches of a Foreign Bank

A *branch of a foreign bank* is defined as any place of business of a foreign bank, located in any state, at which deposits are received, and that is not an agency.

## Agencies

An *agency* of a foreign bank is defined as any place of business of a foreign bank, located in any state, at which credit balances are maintained, checks are paid, money is lent, or, to the extent not prohibited by state or federal law, deposits are accepted from a person or entity that is not a citizen or resident of the United States. Obligations are not to be considered credit balances unless they are

- incidental to, or arise out of the exercise of, other lawful banking powers;
- to serve a specific purpose;
- not solicited from the general public;
- not used to pay routine operating expenses in the United States such as salaries, rent, or taxes;
- withdrawn within a reasonable period of time after the specific purpose for which they were placed has been accomplished; and
- drawn upon in a manner reasonable in relation to the size and nature of the account.

## Commercial Lending Company

A *commercial lending company* is defined as any organization, other than a bank or an organization operating under section 25 of the FRA (12 USC 601-604a), organized under the laws of any state, that maintains credit balances permissible for an agency and engages in the business of making commercial loans. A commercial lending company includes any company chartered under article XII of the banking law of the state of New York. (See Regulation K, section 211.21(g) (12 CFR 211.21(g)).)

## Representative Office

A *representative office* is defined as any office of a foreign bank that is located in any state and is not a federal branch, federal agency, state branch, state agency, or commercial lending company subsidiary. (See section 211.21(x) of Regulation K (12 CFR 211.21(x)).) A representative office is usually established when a bank's board of directors and management desire to establish a physical presence in a foreign market and very limited functions are to be (or can be made) available. A representative office cannot provide

traditional banking services, such as accepting deposits or making loans directly. The office generally serves as a liaison and marketing vehicle for the parent bank in the United States.

A U.S. subsidiary of a foreign bank may be considered to be a representative office of the foreign bank when it holds itself out to the public as a representative of the foreign bank that is acting on behalf of the foreign bank, even if the subsidiary engages in other nonbank business. In addition, an individual or a unit of a subsidiary that acts as a representative of a foreign bank from the location of the nonbank subsidiary may be treated as a representative office. A representative office may make credit decisions only if

- the foreign bank also operates one or more branches or agencies in the United States,
- the loans approved at the representative office are made by a U.S. office of the bank, and
- the loan proceeds are not disbursed in the representative office.

(See section 211.24(d)(1)(ii) of Regulation K (12 CFR 211.24(d)(1)(ii)).)

## CORRESPONDENT BANKS

A correspondent bank provides certain services to banks located in other countries that do not have local offices or whose local office is prohibited from engaging in certain activities. Such a relationship allows a foreign bank to provide trade-related and foreign-exchange services for its multinational customers in a foreign market without having to establish a physical presence in that market.

## PARALLEL-OWNED BANKING ORGANIZATIONS

A parallel-owned banking organization is created when at least one U.S. depository institution and a foreign bank<sup>7</sup> are controlled, either directly or indirectly, by the same person or group of

7. References to "foreign bank" or "foreign parallel bank" also include a holding company of the foreign bank and any U.S. or foreign affiliates of the foreign bank. References to "U.S. depository institution" do not include a U.S. depository institution that is controlled by a foreign bank.

persons<sup>8</sup> who are closely associated in their business dealings or otherwise acting in concert. Parallel-owned banking organizations do not include structures in which one depository institution is a subsidiary of the other or in which the organization is controlled by a company subject to the BHC Act or the Savings and Loan Holding Company Act.<sup>9</sup> The banking agencies<sup>10</sup> consider whether “control” of a depository institution exists when a person or group of persons controls 10 percent or more of any class of the depository institution’s voting shares. Parallel-owned banking organizations are established and maintained for a variety of reasons, including tax and estate planning and the potential risks associated with nationalization. While these reasons may be legitimate and not prohibited by U.S. or foreign law, the structure of such organizations creates or increases certain risks and may make it more difficult for supervisors to monitor and address those risks. On April 23, 2002, the U.S. banking agencies issued a joint agency statement that addresses the potential risks associated with parallel-owned banking organizations. The existence of one or more of the following factors may, depending on the circumstances, warrant additional inquiry regarding the existence of a parallel banking organization:

- An individual or group of individuals acting in concert that controls a foreign bank also controls any class of voting shares of a U.S. depository institution, or financing for persons owning or controlling the shares that are received from, or arranged by, the foreign bank, especially if the shares of the U.S. depository institution are collateral for the stock-purchase loan.
- The U.S. depository institution has adopted particular or unique policies or strategies similar to those of the foreign bank, such as common or joint marketing strategies, sharing of customer information, cross-selling of prod-

ucts, or linked websites.

- An officer or director of the U.S. depository institution either (1) serves as an officer or director<sup>11</sup> of a foreign bank or (2) controls a foreign bank or is a member of a group of individuals acting in concert or with common ties that controls a foreign bank.
- The name of the U.S. depository institution is similar to that of the foreign bank.

Parallel-owned banking organizations present supervisory risks similar to those arising from chain-banking organizations in the United States. The fundamental risk presented by these organizations is that they may be acting in a de facto organizational structure that, because it is not formalized, is not subject to comprehensive consolidated supervision. Therefore, relationships between the U.S. depository institution and other affiliates may be harder to understand and monitor. To reduce these risks, the U.S. banking agencies (1) work with appropriate non-U.S. supervisors to better understand and monitor the activities of the foreign affiliates and owners; (2) share information, as appropriate, with foreign and domestic bank supervisory agencies; and (3) impose special conditions or obtain special commitments or representations related to an application or an enforcement or other supervisory action, when warranted.

Parallel-owned banking organizations may foster additional management and supervisory risks:

- Officers and directors of the U.S. depository institution may be unable or unwilling to exercise independent control to ensure that transactions with the foreign parallel bank or affiliates are legitimate and comply with applicable laws and regulations. As a result, the U.S. depository institution may be the conduit or participant in a transaction that violates U.S. law or the laws of a foreign country, or that is designed to prefer a foreign bank or nonbank entity in the group, to the detriment of the U.S. depository institution.
- Money-laundering concerns may be heightened due to the potential lack of arm’s-length transactions between the U.S. depository institution and the foreign parallel bank. Specifically, the flow of funds through wires, pouch

8. The term “persons” includes both business entities and natural persons, which may or may not be U.S. citizens.

9. A bank holding company or savings and loan holding company, however, may be a component of a parallel-owned banking organization. This situation may arise when a bank holding company or savings and loan holding company controls the U.S. depository institution, and the holding company, in turn, is controlled by a person or group of persons who also controls a foreign bank.

10. The Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

11. The sharing of a director, by itself, is unlikely to indicate common control of the U.S. and foreign depository institutions.

activity, and correspondent accounts may be subject to less internal scrutiny by the U.S. depository institution than usually is warranted.<sup>12</sup> This risk is greatly increased when the foreign parallel bank is located in an offshore jurisdiction or other jurisdiction that limits exchange of information through bank secrecy laws, especially if the jurisdiction has been designated as a “non-cooperating country or territory” or the jurisdiction of the foreign bank has been found to be of primary money-laundering concern under the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001.

- Securities, custodial, and trust transactions may be preferential to the extent that assets, earnings, and losses are artificially allocated among parallel banks. Similarly, low-quality assets and problem loans can be shifted among parallel banks to manipulate earnings or losses and avoid regulatory scrutiny. Also, if the foreign parallel bank were to begin experiencing financial difficulties, the foreign bank or the common owners might pressure the U.S. depository institution to provide credit support or liquidity to an affiliate in excess of the legal limits of 12 USC 371c and 371c-1.
- The home country of the foreign parallel bank may have insufficient mechanisms or authority to monitor changes in ownership or to

ensure arm’s-length intercompany transactions between the foreign parallel bank and other members of the group, including the U.S. depository institution, or to monitor concentrations of loans or transactions with third parties that may present safety-and-soundness concerns to the group.

- Capital may be generated artificially through the use of international stock-purchase loans. Such loans can be funded by the U.S. depository institution to the foreign affiliate or to a nonaffiliate with the purpose of supporting a loan back to the foreign affiliate and used to leverage the U.S. depository institution or vice versa. This concern is heightened for parallel-owned banking organizations if the foreign bank is not adequately supervised.
- Political, legal, or economic events in the foreign country may affect the U.S. depository institution. Events in the foreign country, such as the intervention and assumption of control of the foreign parallel bank by its supervisor, may trigger a rapid inflow or outflow of deposits at the U.S. depository institution, thereby affecting liquidity. Foreign events may increase reputational risk to the U.S. depository institution. In addition, these events may adversely affect the foreign bank owner’s financial resources and decrease the ability of the foreign bank owner to provide financial support to the U.S. depository institution. Foreign law may change without the U.S. depository institution or the banking agencies becoming aware of the effect of legal changes on the parallel-owned banking organization, including the U.S. depository institution.
- Parallel-owned banking organizations may seek to avoid legal lending limits or limitations imposed by securities or commodities exchanges or clearinghouses on transactions by one counterparty, thereby unduly increasing credit risk and other risks to the banking organizations and others.

To minimize risks, the U.S. banking agencies coordinate the supervision of a parallel-owned banking organization’s U.S. operations. The supervisory approach may include unannounced coordinated examinations if more than one regulator has examination authority. Such examinations may be conducted if regulators suspect irregular transactions between parallel-owned banks, such as the shifting of problem assets between the depository institutions. Factors to consider in determining whether to

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12. On October 28, 2002, the U.S. Department of the Treasury’s regulation to implement sections 313 and 319(b) of the USA Patriot Act became effective. (See 31 CFR 103.177 and 103.185.) The regulation implemented new provisions of the Bank Secrecy Act that relate to foreign correspondent accounts. A covered financial institution (CFI) (a financial institution that is covered by the regulation) is prohibited from establishing, maintaining, administering, or managing a correspondent account in the United States for, or on behalf of, a foreign shell bank (a foreign bank that has no physical presence in any country) that is not affiliated with a U.S.-domiciled financial institution or with a foreign bank that maintains a physical presence in the United States or a foreign country and that is supervised by its home-country banking authority. A CFI must take reasonable steps to ensure that a correspondent account of a foreign bank (an account established by a CFI for a foreign bank to receive deposits from, to make payments or other disbursements on behalf of a foreign bank, or to handle other financial transactions related to the foreign bank) is not being used to indirectly provide banking services to foreign shell banks. The regulation includes recordkeeping requirements and required account-termination procedures that are to be used by CFIs having correspondent accounts of foreign banks. See SR-05-9 for a discussion of the Patriot Act’s requirements for a financial institution’s customer identification program. A customer identification program should be part of an institution’s overall anti-money-laundering and BSA compliance program. See also the *FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual* and SR-10-9.



conduct coordinated reviews of an organization's U.S. operations include: (1) intercompany and related transactions; (2) strategy and management of the parallel-owned banking organization; (3) political, legal, or economic events in the foreign country; and (4) compliance with commitments or representations made or conditions imposed in the application process, or conditions pursuant to prior supervisory action.

The U.S. depository institution's board of directors and senior management are expected to be cognizant of the risks associated with being part of a parallel-owned banking structure, especially with respect to diversion of a depository institution's resources, conflicts of interest, and affiliate transactions. The depository institution's internal policies and procedures should provide guidance on how personnel should interact with affiliates. The Federal Reserve and other U.S. banking agencies will expect to have access to such policies, as well as to the results of any audits of compliance with the policies. The agencies will seek an overview of the entire organization, as well as a better understanding of how foreign bank affiliates are supervised. Authorized bank regulatory supervisory staff will work with foreign supervisors to better understand the activities of the foreign affiliates and owners. As appropriate and feasible, and in accordance with applicable law, such authorized staff will share information regarding material developments with foreign and domestic supervisory agencies that have supervisory responsibility over relevant parts of the parallel-owned banking organization.

## DOMESTIC AND FOREIGN SUBSIDIARIES

Domestic subsidiaries are any majority-owned companies, other than Edge Act or agreement corporations, domiciled in the United States and its territories and possessions. Foreign subsidiaries are any majority-owned or -controlled companies domiciled in a foreign country or any Edge Act or agreement corporation. Section 211.13 of Regulation K (12 CFR 211.13) requires foreign subsidiaries to maintain effective systems of records, controls, and reports to keep bank management informed of their activities and conditions. In particular, these systems

are to provide information on risk assets, exposure to market risk, liquidity management, operations, internal controls, and conformance with management policies. Reports on risk assets must be sufficient enough to allow for an appraisal of credit quality and an assessment of exposure to loss; for that purpose, they must provide full information on the condition of material borrowers. Reports on the operations and controls are to include internal and external audits of the branch or subsidiary.

On-site examinations of foreign subsidiaries are sometimes precluded because of objections voiced by foreign directors, minority shareholders, or local bank supervisors. In addition, secrecy laws in some countries may preclude on-site examinations. When on-site examinations cannot be performed, foreign subsidiary reports submitted according to section 211.13 and reports submitted to foreign banking authorities must serve as the basis for evaluating the bank's investment.

Additionally, Regulation K allows for investments in foreign companies to be made under the general-consent provisions without prior approval of the Board. These investments can be sizable and can pose significant risk to the banking organization. Investments in foreign subsidiaries should be reviewed for compliance with the FRA and investment limitations in Regulation K. (See Regulation K, sections 211.8 and 211.9.)

## SIGNIFICANT SUBSIDIARIES

As used in the consolidation instructions for certain regulatory reports, "significant subsidiaries" refers to subsidiaries that meet any one of the following tests:

- a majority-owned subsidiary in which the bank's direct and indirect investment and advances represent 5 percent or more of the parent bank's equity capital accounts,
- a majority-owned subsidiary whose gross operating revenues amount to 5 percent or more of the parent bank's gross operating revenues,
- a majority-owned subsidiary whose "income (loss) before income taxes and securities gains or losses" amounts to 5 percent or more of the parent bank's "income (loss) before income taxes and securities gains or losses," or
- a majority-owned subsidiary that is the parent

of one or more subsidiaries that, when consolidated, constitute a “significant subsidiary” as defined above.

## ASSOCIATED COMPANIES

Associated companies are those in which the bank directly or indirectly owns 20 percent to 50 percent of the outstanding common stock, unless the bank can rebut to the Federal Reserve the presumption of exercising significant influence. However, as noted above, for purposes of section 23A, affiliation is defined by 25 percent share ownership. Because of the absence of direct or indirect control, regulators have no legal authority to conduct full examinations of this type of company. Investments in these companies are generally appraised in the same way as commercial loans, that is, by a credit analysis of the underlying financial information.

## CHAIN-BANKING SYSTEMS

Chain-banking systems exist when an individual (or group of individuals) is a principal in two or more banking institutions, in either banks or BHCs or a combination of both types of institutions. In these systems, the possibility exists that problems in one or more of the entities may adversely affect the safety and soundness of the bank entities because of pressure exerted by their common principal (or principals). Examiners should determine whether the bank is a member of a chain. If so, the extent of its relationship with other links of the chain should be determined, as well as the effects these relationships have on the bank.

## REAL ESTATE INVESTMENT TRUSTS AND OTHER RELATED ORGANIZATIONS

Although a bank, its parent holding company, or its nonbank affiliate may not have a direct investment in an “other related organization,” the bank may sponsor, advise, or influence the activities of these companies. The most notable examples are real estate investment trusts (REITs) or special-purpose vehicles (SPVs). Transactions between the bank and REITs and

between other investment companies sponsored or advised by the bank are subject to the limitations in section 23A and Regulation W. In other cases, because of nonownership or a less-than-majority ownership, legal authority to conduct an examination does not exist.

A REIT may be considered an affiliate if it is sponsored and advised on a contractual basis by the member bank or by any subsidiary or affiliate of the member bank. In these cases, transactions between the bank and an affiliated REIT are subject to the requirements of section 23A. Because a REIT frequently carries a name that closely identifies it with its sponsoring bank or BHC, failure of the REIT could have an adverse impact on public confidence in the holding company and its subsidiaries.

The examiner should be aware of all significant transactions between the bank under examination and its related REIT in order to determine conflicts of interest and contingent risks. In several instances, REITs have encountered serious financial problems and have attempted to avoid failure by selling questionable assets to, or swapping these assets with, their bank affiliates. In other instances, because of the adversary relationship, REITs have been encouraged to purchase assets of inferior quality from their related organizations.

## BANK HOLDING COMPANIES

As defined in section 2 of the BHC Act of 1956 (12 USC 1841 et seq.), a BHC is any company that directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the bank or company; that controls in any manner the election of a majority of the directors or trustees of the bank or company; or that the Board determines, after notice and opportunity for hearing, directly or indirectly exercises controlling influence over the management or policies of the bank or company. A bank and its parent holding company are considered affiliates when the holding company controls the bank in a manner consistent with the definition of control in section 23A of the FRA. Section 23A exempts from the quantitative and collateral requirements of the law all transactions (except for the purchase of low-quality assets) between “sister” banks (banks with 80 percent or more common own-

ership) in a BHC system. A low-quality asset is any asset (1) classified “substandard,” “doubtful,” or “loss,” or treated as “other loans especially mentioned” in the most recent federal or state examination report; (2) on nonaccrual status; (3) with principal or interest payments more than 30 days past due; or (4) whose terms have been renegotiated or compromised due to the deteriorated financial condition of the borrower.

Under the BHC Act, the Federal Reserve has authority to inspect BHCs and their nonbank subsidiaries. The Federal Reserve requires periodic inspections of all BHCs, the frequency of which is based on the size, complexity, and condition of the organization. If a BHC is inspected at the same time as the examination of its state member bank subsidiaries, the examiner at the bank should collaborate closely with inspection personnel on those holding company issues that directly affect the condition of the bank. When the BHC inspection is not conducted simultaneously with the examination, the bank examiner should closely review the most recent report of inspection and may also need to consult the FR Y-series of reports regularly submitted to the Federal Reserve System by BHCs.

Many banks are owned by BHCs. To understand the effects of the holding company structure on the subsidiary bank, the examiner should evaluate the overall financial support provided by the parent company, quality of supervision and centralized functions provided, and appropriateness of intercompany transactions. Since financial and managerial issues at the BHC and subsidiary bank levels are so closely connected, it is strongly recommended that a holding company inspection and its respective bank examination(s) be conducted at the same time. A combined examination/inspection report, as discussed in SR-94-46, is available to facilitate this coordination when the lead subsidiary is a state member bank.

## Financial Support

The holding company structure can provide its subsidiary bank with strong financial support because of its greater ability to attract and shift funds to less capital-intensive areas and to enter markets in a wider geographic area than would otherwise be possible. Financial support may

take the form of capital (equity or debt) or funding of loans and investments. In general, the lower the parent BHC’s leverage, the more it is able to serve as a source of financial strength to its bank subsidiaries. This is because less cash flow will be required from the banks for debt servicing and the parent has more borrowing capacity, which could be used to provide funds to the bank. When the financial condition of the holding company or its nonbanking subsidiaries is unsound, the operations of its subsidiary bank can be adversely affected. To service its debt or provide support to another subsidiary that is experiencing financial difficulty, the holding company may involve its bank subsidiary in the following imprudent actions:

- engaging in high-risk investments to obtain increased yields,
- purchasing or swapping its high-quality assets for the parent’s or other affiliate’s lower-quality assets,
- entering into intercompany transactions that are detrimental because of inordinately high fees or inadequate or unnecessary services,
- paying excessive dividends, or
- making improper tax payments or unfavorably altering its tax situation.

Even when the holding company’s structure is financially sound, the holding company’s ability to sell short- or long-term debt and to pass the proceeds down to its bank subsidiary in the form of equity capital may still present problems. This procedure is frequently referred to as “double leveraging,” the amount of the equity investment in the bank subsidiary that is financed by debt. Problems may arise when the holding company must service its debt out of dividends from the subsidiary, and the subsidiary, if it encounters an earnings problem or is prevented by regulatory agreement or action, may not be able to pass dividends up to its parent.

Another potential problem may develop when the holding company sells its commercial paper and funds its subsidiary’s loans with those proceeds. This may cause a liquidity problem if the maturities of the commercial paper sold and loans funded are not matched appropriately and if the volume of such funding is large in relation to the subsidiary’s overall operations.

On April 24, 1987, the Federal Reserve adopted a policy statement on the responsibility of BHCs to act as sources of financial and

managerial strength to their subsidiary banks. The Board's statement reiterates a general policy that has been expressed on numerous occasions in accordance with authority that is provided under the BHC Act and the enforcement provisions of the FDI Act.

## BHC Supervision of Subsidiaries

BHCs use a variety of methods to supervise their bank subsidiaries, including

- having holding company senior officers serve as directors on the bank's board;
- establishing reporting lines from senior bank management to corporate staff;
- formulating or providing input into key policies; and
- establishing management information systems, including internal audit and loan review.

As part of the evaluation of bank management, the examiner should be aware of these various control mechanisms and determine whether they are beneficial to the bank. Examiners should keep in mind that, even in a BHC organization, the directors and senior management of the bank are ultimately responsible for operating it in a safe and sound manner.

In addition, many bank functions (investment management, asset/liability management, human resources, operations, internal audit, and loan review) may be performed on behalf of the bank by its parent BHC or by a nonbank affiliate. These functions are reviewed at inspections of the BHC. Examiners at the bank should be aware of the evaluation of these functions by inspection personnel, either at a concurrent inspection or in the report of a prior inspection. In addition, a review of these same issues at the level of the subsidiary bank is useful to determine compliance with corporate policies, corroborate inspection findings, and identify any inappropriate transactions that may have been overlooked in the more general, top-down review at the parent level.

## FINANCIAL HOLDING COMPANIES

Section 4(k) of the BHC Act authorizes affiliations among banks, securities firms, insurance

firms, and other financial companies. It provides for the formation of financial holding companies (FHCs) and allows a BHC or foreign bank that qualifies as an FHC to engage in a broad range of activities that are (1) defined by the GLB Act to be financial in nature or incidental to a financial activity or (2) determined by the Board, in consultation with the secretary of the Treasury, to be financial in nature or incidental to a financial activity or that are determined by the Board to be complementary to a financial activity, which would not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

Certain conditions must be met for a BHC or a foreign bank to be deemed an FHC and to engage in the expanded activities. BHCs that do not qualify as FHCs are limited to engaging in those nonbanking activities that are permissible under section 4(c)(8) of the BHC Act. Section 4(k) of the BHC Act authorizes an FHC to engage in designated financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities.

## Supervisory Oversight

The Federal Reserve has supervisory oversight authority and responsibility for BHCs that operate as FHCs and for BHCs that are not FHCs. The GLB Act sets parameters for operating relationships between the Federal Reserve and other regulators. The GLB Act differentiates between the Federal Reserve's relations with (1) depository institution regulators and (2) functional regulators, which include insurance, securities, and commodities regulators. The Federal Reserve's relationships with functional regulators will, in practice, depend on the extent to which an FHC is engaged in functionally regulated activities; those relationships will also be influenced by existing working arrangements between the Board and the functional regulator.

The Federal Reserve's supervisory oversight role is that of an umbrella supervisor concentrating on a consolidated or group-wide analysis of an organization. Umbrella supervision is not an extension of more traditional bank-like supervision throughout an FHC. The FHC framework is consistent with and incorporates principles that are well established for BHCs. The FHC supervisory policy focuses on addressing super-

visory practice for and relationships with FHCs, particularly those that are engaged in securities or insurance activities. (See SR-00-13.)

The Federal Reserve is responsible for the consolidated supervision of FHCs. The Federal Reserve thus assesses the holding company on a consolidated or group-wide basis. The objective is to ensure that the holding company does not threaten the viability of its depository institution subsidiaries. Depository institution subsidiaries of FHCs are supervised by their appropriate primary bank or thrift supervisor (federal and state). However, the GLB Act did not change the Federal Reserve's role as the federal BHC supervisor.

Nonbank (or nonthrift) subsidiaries engaged in securities, commodities, or insurance activities are to be supervised by their appropriate functional regulators. Examples of these functionally regulated subsidiaries include a broker, dealer, investment adviser, and investment company registered with and regulated by the Securities and Exchange Commission (SEC) (or, in the case of an investment adviser, registered with any state); an insurance company or insurance agent subject to supervision by a state insurance regulator; and a nonbank subsidiary engaged in activities regulated by the Commodity Futures Trading Commission (CFTC).

As the umbrella supervisor, the Federal Reserve will seek to determine that FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of affiliated depository institutions. Oversight of FHCs (particularly those engaged in a broad range of financial activities) at the consolidated level is important because the risks associated with an FHC's activities can cut across legal entities and business lines. The purpose of FHC supervision is to identify and evaluate, on a consolidated or group-wide basis, the significant risks that exist in a diversified holding company to assess how these risks might affect the safety and soundness of depository institution subsidiaries.

The Federal Reserve's focus will be on the financial strength and stability of FHCs, their consolidated risk-management processes, and overall capital adequacy. The Federal Reserve will review and assess internal policies, reports, and procedures, as well as the effectiveness of the FHC consolidated risk-management process. The appropriate bank, thrift, or functional regulator will continue to have primary responsibility

for evaluating risks, hedging, and risk management at the legal-entity level for the entity or entities that it supervises.

## Permissible Activities

Permissible activities for FHCs include any activity that the Board determined to be closely related to banking under section 4(c)(8) of the BHC Act by regulation that was in effect prior to November 12, 1999, or by order that was in effect on November 12, 1999. This includes the long-standing "laundry list" of nonbanking activities for BHCs. (See section 225.28(b) of Regulation Y.) Section 225.86(a)(2) of Regulation Y lists the nonbanking activities approved for BHCs by Board order as of November 12, 1999.<sup>13</sup>

Section 4(k)(4)(G) of the BHC Act also defines "financial in nature" as any activity (1) in which a BHC may engage outside the United States and (2) that the Board has determined, by regulation or interpretations issued under section (4)(c)(13) of the BHC Act that were in effect on November 11, 1999, to be usual in conducting banking or other financial services abroad. Section 225.86(b) of Regulation Y lists three activities that the Board has found to be usual in connection with the transaction of banking or other financial operations abroad.<sup>14</sup> The activities are (1) providing management consulting services; (2) operating a travel agency; and (3) organizing, sponsoring, and managing a mutual fund. The conduct of each activity has certain prescribed limitations. Management consulting services must be advisory and not allow the FHC to control the person to whom the services are provided. These services, however, may be offered to any person on nonfinancial matters. An FHC may also operate a travel agency in connection with financial services offered by the FHC or others. Finally, a mutual fund organized, sponsored, or managed by an FHC may not exercise managerial control over the companies in which the fund invests, and the FHC must reduce its ownership of the fund, if any, to less than 25 percent of the equity

13. Section 20 company activities are not included in this list. Section 4(k)(4)(E) of the BHC Act authorizes FHCs to engage in securities underwriting, dealing, and market-making activities in a broader form than was previously authorized by Board order.

14. See section 211.10 of Regulation K (12 CFR 211.10).

of the fund within one year of sponsoring the fund (or within such additional period as the Board permits).

The activities that a BHC is authorized to engage in outside the United States under section 211.10 of Regulation K have been either (1) authorized for FHCs in a broader form by the GLB Act (for example, underwriting, distributing, and dealing in securities and underwriting various types of insurance) or (2) authorized in the same or a broader form in Regulation Y (for example, data processing activities; real and personal property leasing; and acting as agent, broker, or adviser in leasing property). Section 4(k)(4)(G) of the BHC Act and section 225.86 of Regulation Y only authorize FHCs to engage in the activities that are listed in section 211.10 of Regulation K, as interpreted by the Board. The Board has also approved activities found in individual orders issued under section 4(c)(13) of the BHC Act. Section 4(k)(4)(G) and Regulation Y do not authorize an FHC to engage in activities that the Board authorized a BHC to provide in individual orders issued under section 4(c)(13) of the BHC Act.

The remaining activities authorized by section 4(k)(4) of the BHC Act are those that are defined to be “financial in nature” under section 4(k)(4)(A) through (E), (H), and (I). (See section 225.86(c) of Regulation Y.) These activities include issuing annuity products and acting as principal, agent, or broker for purposes of insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death. Permissible insurance activities as principal include reinsuring insurance products. An FHC acting under section 4(k)(4) of the BHC Act may conduct insurance activities without regard to the restrictions on the insurance activities imposed on BHCs under section 4(c)(8). (See section 3905.0 of the *Bank Holding Company Supervision Manual* for more information pertaining to the activities of FHCs.)

## INTERCOMPANY TRANSACTIONS

As with the supervision of subsidiaries, intercompany transactions should be reviewed at both the parent level during inspections and at the subsidiary-bank level during examinations. The transactions should comply with sections 23A and 23B of the FRA, Regulation W, and

should not otherwise adversely affect the financial condition of the bank.

## Intercompany Tax Payments

As set forth in the policy statement regarding intercorporate income tax accounting transactions of BHCs and state-chartered member banks (September 20, 1978), Federal Reserve policy relative to intercompany tax payments is to treat the bank as a separate taxpayer whose tax payments to its parent should not exceed payments it would make on a separate-entity basis. Payments should not be made to the parent before the time payments are or would have been made to the Internal Revenue Service. Refunds to the bank should be timely. Individual situations may result in complicated issues, and the examiner should consult with Reserve Bank personnel before reaching conclusions concerning a particular transaction. BHC inspection report comments and bank examination report comments should be consistent concerning the nature and propriety of intercompany transactions.

## Management and Other Fees

Banks often obtain goods and services from the parent BHC or an affiliated nonbank subsidiary. These arrangements may benefit the bank, since the supplier may offer lower costs because of economies of scale, such as volume dealing. Furthermore, banks may be able to purchase a package of services that otherwise might not be available. However, because of the relationship between the bank and the supplier, examiners should ensure that the fees being paid represent reasonable reimbursement for goods and services received. Fees paid by the bank to the parent or nonbank affiliates should have a direct relationship to, and be based solely on, the fair value of goods and services provided. Fees should compensate the affiliated supplier only for providing goods and services that meet the legitimate needs of the bank.

Banks should retain satisfactory records that substantiate the value of goods and services received, their benefit to the bank, and their cost efficiencies. There are no other minimum requirements for records, but an examiner should be able to review the records maintained and deter-

mine that fees represent reasonable payment. In general, the supplier will decide on the amount to be charged by using one of two methods:

- reimbursement for cost of goods or services or
- comparative fair-market value.

Either of these methods may be acceptable as long as the bank can substantiate that the fees paid are reasonable for the value received. Basing fees on costs may be the most common approach since market comparisons often are difficult to obtain. A holding company may be able to offer a number of services on a cost basis to a subsidiary bank, any one of which might be contracted elsewhere for less. However, in the aggregate, the services may be cost effective or produce economies of scale for the entire organization. Nevertheless, having one or more subsidiary banks pay excessive fees for services to subsidize other unprofitable operations is not an acceptable practice.

When the servicer incurs overhead expenses, recovery of those costs is acceptable to the extent they represent a legitimate and integral part of the service rendered. Overhead includes salaries and wages, occupancy expenses, utilities, payroll taxes, supplies, and advertising. Debt-service requirements of holding companies, shareholders, or other related organizations are not legitimate overhead expenses for a subsidiary bank.

Generally, the payment of excessive fees is considered an unsafe and unsound practice. When fees are not justified, appear excessive, do not serve legitimate needs, or are otherwise abusive, the examiner should inform the board of directors through appropriate criticism in the report of examination.

## Dividends

Dividends represent a highly visible cash outflow by banks. If the dividend-payout ratio exceeds the level at which the growth of retained earnings can keep pace with the growth of assets, the bank's capital ratios will deteriorate. Examiners should evaluate the appropriateness of dividends relative to the bank's financial condition, prospects, and asset-growth forecast.

## Purchases or Swaps of Assets

Asset purchases or swaps between affiliates create the potential for abuse. Regulatory concern focuses on the fairness of such asset transactions, their financial impact, and timing. Fairness and financial considerations include the quality and collectibility of such assets and liquidity effects. Asset exchanges may be a mechanism to avoid regulations designed to protect subsidiary banks from becoming overburdened with nonearning assets.

## Compensating Balances

A subsidiary bank may be required to maintain excess balances at a correspondent bank that lends to other parts of the holding company organization, possibly to the detriment of the bank. The subsidiary bank may be foregoing earnings on such excess funds, which may adversely affect its financial condition.

## Split-Dollar Life Insurance

Split-dollar life insurance is a type of life insurance in which the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, or death benefit, or both. In some circumstances, when the subsidiary bank pays all or substantially all of the insurance premiums, an unsecured extension of credit from the bank to its parent holding company generally results because the bank has paid the holding company's portion of the premium, and the bank will not be fully reimbursed until later. In other arrangements, when the parent uses the insurance policy as collateral for loans from the subsidiary bank, the loan may not meet the collateral requirements of section 23A or Regulation W. In addition, split-dollar arrangements may not comply with section 23B or Regulation W if the return to the bank is not commensurate with the size and nature of its financial commitment. Finally, split-dollar arrangements may be considered unsafe and unsound, which could be the case if the bank is paying the entire premium but is not the beneficiary, or if it receives less than the entire proceeds of the policy. (See SR-93-37.)

## Other Transactions with Affiliates

Checking accounts of the parent or nonbank subsidiaries at subsidiary banks present the potential for overdrafts, which are regarded as unsecured extensions of credit to an affiliate by the subsidiary bank. In general, a subsidiary bank should be adequately compensated for its services or for the use of its facilities and personnel by other parts of the holding company organization. In addition, a subsidiary bank should not pay for expenses for which it does not receive a benefit (for example, the formation expenses of a one-BHC).

Situations sometimes arise in which more than one legal entity in a banking organization shares offices or staff. In certain cases, it can be hard to determine whether a legal entity is operating within the scope of its permissible activities. In addition, a counterparty may be unclear as to which legal entity an employee is representing. Finally, there may be expense-allocation problems and, thus, issues pertaining to sections 23A and 23B of the FRA or Regulation W. Examiners should be aware of these concerns and make sure that institutions have the proper records and internal controls to ensure an adequate separation of legal entities. (See SR-95-34.)

## EVALUATION OF INVESTMENTS IN AND LOANS TO BANK-RELATED ORGANIZATIONS

To properly evaluate affiliates and other bank-related organizations<sup>15</sup> relative to the overall condition of the bank, the examiner must

- know the applicable laws and regulations that define and establish limitations with respect to investments in, and extensions of credit to, affiliates and
- analyze thoroughly the propriety of the related organizations' carrying value, the nature of the relationships between the bank and its related organizations, and the effect of such

15. Information about related organizations and interlocking directorates and officers can be obtained from the bank holding company form FR Y-6 and SEC form 10-K, if applicable, or from other required domestic and foreign regulatory reports. Further information on business interests of directors and principal officers of the bank can be obtained by reviewing information maintained by the bank in accordance with the Board's Regulation O.

relationships on the affairs and soundness of the bank.

The propriety of the carrying value of a bank's investment in any related organization is determined by evaluating the balance sheet and income statement of the company in which the bank has the investment. At times, this may not seem important in relation to the overall condition of the bank because the amount invested may be small relative to the bank's capital. It may appear that a cursory appraisal of the company's assets would therefore be sufficient. However, the opposite is often true. Even though a bank's investment in a subsidiary or associated company is relatively small, the underlying fiduciary or compliance obligations may be substantial and may greatly exceed the total amount of the reported investment. If the subsidiary experiences large losses, the bank may have to recapitalize the subsidiary by injecting much more than its original investment to protect unaffiliated creditors of the subsidiary or protect its own reputation.

When examining and evaluating the bank's investment in and loans to related organizations, classified assets held by such companies should first be related to the capital structure of the company and then be used as a basis for classifying the bank's investment in and loans to that company.

One problem that examiners may encounter when they attempt to evaluate the assets of some subsidiaries and associated companies is inadequate on-premises information. This may be especially true of foreign investments and associated companies in which the bank has less than a majority interest. In those instances, the examiner should request that adequate information be obtained during the examination and should establish agreed-on standards for that information in the future. The examiner should insist that the organization have adequate supporting information readily obtainable or available in the bank and that the information be of sufficient quality to allow for an informed evaluation of the investment. Bank management, as well as regulatory authorities, must be adequately informed of the condition of the companies in which the bank has an investment. For subsidiary companies, it is necessary that bank representatives be a party to policy decisions, have some on-premises control of the company (such as board representation), and have audit authority. In the case of an associated company, the



bank should participate in company affairs to the extent practicable. Information documenting the nature, direction, and current financial status of all such companies should be maintained at the bank's head office or maintained regionally for global companies. Full audits by reputable certified public accountants are often used to provide much of this information.

For foreign subsidiaries, in addition to the audited financial information prepared for management, the bank should have on file the following:

- reports prepared according to the Board's Regulation K;
- reports prepared for foreign regulatory authorities;
- information on the country's regulatory structure, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, and fiscal policy, political goals, and a determination as to the potential risk of expropriation; and
- adequate information to review compliance with the investment provisions of Regulation K. (For each investment, information should be provided on the type of investment (equity, binding commitments, capital contributions, subordinated debt), dollar amount of the investment, percentage ownership, activities conducted by the company, legal authority for such activities, and whether the investment was made under Regulation K's general-consent, prior-notice, or specific-consent procedures. With respect to investments made under the general-consent authority, information also must be maintained that demonstrates compliance with the various limits set out in section 211.9 of Regulation

K. (See Regulation K, sections 211.8 and 211.9.)

For agricultural credit corporations, the central point of contact or the examiner-in-charge normally decides when to examine such an entity. A complete analysis of the entity's activities should always be performed if

- the corporation is not supervised by the Federal Intermediate Credit Bank (FICB),
- the most recent FICB examination occurred over a year ago, or
- the most recent FICB examination indicates that the corporation is in less than satisfactory condition.

The extent of any analysis should be based on the examiner's assessment of the corporation's effect on the parent bank. That analysis should include, but not be limited to, a review of

- asset quality;
- the volatility, maturity, and interest-rate sensitivity of the asset and liability structures; and
- the bank's liability for guarantees issued on behalf of the corporation.

When the same borrower is receiving funds from both the corporation as well as the parent bank and the combined exposure exceeds 25 percent of total consolidated capital, the debt should be detailed on the concentration page of the examination report. The consolidation procedures listed in the instructions for the preparation of Consolidated Reports of Condition and Income should be used when consolidating the figures of the corporation with those of its parent.

# Bank-Related Organizations

## Examination Objectives

Effective date April 2010

## Section 4052.2

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1. To determine if policies, procedures, and internal controls for bank-related organizations are adequate.
2. To determine if the bank's and its nonbank subsidiaries' management are complying with the established policies.
3. To determine the bank's compliance with applicable laws and regulations involving intercompany and other transactions.
4. To evaluate the bank's investment in, and loans to, its related organizations, as well as the propriety of their carrying values.
5. To determine the relationships between the bank and its related organizations and the effects of those relationships on the operations and safety and soundness of the bank.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

### PRE-EXAMINATION ANALYSIS

During the pre-examination analysis of the bank, it should be determined which related organizations should be examined in depth. The criteria for that determination are as follows:

1. All operating subsidiaries should be examined concurrently with the regular examination of the parent bank, unless such examination is specifically waived by the Federal Reserve Bank.
2. Other subsidiaries should be examined except when relationships between the subsidiary, its parent, and other related organizations are fully disclosed by material on hand and when the subsidiary's condition or operations are determined not to be detrimental to the safety and soundness of the bank. Factors to be considered in making the determination whether to examine a subsidiary are as follows:
  - the legal limitations on the Board's authority to examine a functionally regulated subsidiary, including whether
    - examination and other information is available for review that has been reported to a functionally regulated supervisory authority;
    - whether the functionally regulated supervisor's information is adequate to make a determination that a subsidiary's activities pose a material risk to an affiliated depository institution (DI); and
    - an examination of the subsidiary is necessary to be adequately informed of the systems for monitoring and controlling the operational and financial risks posed to any DI;
  - the bank's percent of ownership and dollar amount of investment in the subsidiary
  - nature of the subsidiary's business
  - types and amounts of intercompany transactions
  - types and amounts of participations and purchased, sold, or swapped assets between the subsidiary and the bank or other related organizations
  - types of services performed by the sub-

subsidiary for the bank or other related organizations

- outstanding contingent liabilities by the bank in favor of the subsidiary
  - the bank's potential contingent liabilities, moral or legal, as a result of litigation, claims, or assessments pending against the subsidiary
3. If practical under the circumstances, the parent holding company and nonbank affiliates (subject to the previously discussed limitations for functionally regulated affiliates) should be inspected in conjunction with the examination of the lead state member bank. The decision to coordinate the timing of the bank holding company inspection and the state member bank examination should be based on the nature and extent of interaction between the bank and its parent holding company and nonbank affiliates. Factors to be considered in making the decision to coordinate the examination are as follows:
    - dollar amount of loans or advances by the bank
    - nature of business of the nonbank affiliates
    - types and amount of intercompany transactions
    - types and amounts of participations and other assets purchased, sold, or swapped
    - types of services performed for, or by, the bank and fees paid or received
    - outstanding contingent liabilities by the bank in favor of its parent or nonbank affiliates

Factors to be considered in determining whether to examine nonbanking subsidiaries of the parent holding company under inspection are detailed in the *Bank Holding Company Supervision Manual*.

### EXAMINATION PROCEDURES

The following procedural steps should be performed for all banks that have related organizations.

1. If selected for implementation, complete or update the bank-related organizations sec-

- tion of the internal control questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures.
  3. When appropriate, obtain the following reports or forms prepared or filed since the preceding examination:
    - a. annual report on SEC Form 10-K
    - b. current report on SEC Form 8-K
    - c. quarterly report on SEC Form 10-Q
    - d. semiannual report on Federal Reserve FR Y-8
    - e. annual fiscal year-end report on Federal Reserve FR Y-6
    - f. annual report of foreign banking organizations FR Y-7
    - g. report of changes in organizational structure FR Y-10
    - h. annual report to shareholders
    - i. required reports under Federal Reserve Regulation K and to foreign banking authorities for foreign subsidiaries
    - j. subsidiary and affiliate reports prepared by examiners
    - k. federal reports of examination for non-banking subsidiaries

See section 4150.1 for information on certain other reports that may be required for bank-related organizations.
  4. Request that the bank provide a list of the names of all related organizations; the list should set forth the loans to, and investments in, these organizations and any management official interlocks among these organizations and the banks.
  5. Circulate a list of the names of the related organizations and the loans to, and investments in, these organizations. This list should be circulated among the examiners assigned to each bank department. The accuracy and completeness of this information should be verified by the recipients.
  6. Obtain, from the examiners assigned to other assets and other liabilities, information concerning receivables from, or payables to, related organizations.
  7. Review the bank's files and reports obtained in step 3, and transcribe for the workpapers pertinent financial data and comments regarding related organizations.
  8. Review fees paid by the bank to related organizations, bank insider-related organizations, and stockholders. Determine that the fees represent reasonable reimbursement for goods and services received by
    - a. determining the method used to compute the charge to the bank for goods or services (cost, cost plus profit, fair market value);
    - b. reviewing documentation maintained by the bank to substantiate the fair value of the goods or services received, their benefit to the bank, and the cost efficiencies of the alternative selected;
    - c. comparing the schedule of fees currently in effect with those in effect 12 months ago;
    - d. comparing the fees paid during the last three months with those paid for the same period one year ago; and
    - e. reviewing formal written employee sharing agreements to determine the basis for the amounts paid by the bank and to determine if they are reasonable.
  9. On the basis of the information obtained above, review the following for each related organization:
    - a. the quality of loans, investments, and future commitments to any related organization
    - b. the nature and volume of transactions between the related organization and the bank and
      - the extent of any participations and the purchase, sale, or swap of assets between the bank and the related organizations, as well as the propriety of the transactions and related considerations;
      - the fees these organizations charge the bank for services rendered and the reasonableness of those fees;
      - cash transfers to or from a related organization in connection with consolidated income tax obligations (Amounts paid should be based on that amount due if a separate return was filed, and should be supported with written tax-sharing contractual agreements, which would include how tax payments would be made and how tax refunds would be distributed. Tax payments should be paid to allow time to reasonably permit the required estimated payments or final settlements to be made to the IRS or other taxing authority);
      - fees received by the bank from the organization for the use of bank per-

- sonnel, premises, marketing services, and equipment, and the adequacy of those fees; and
  - any agreements, guarantees, pledges, or hypothecations between the bank and any related organization, if they are properly reflected on the books of the bank, and if there are any apparent conflicts of interest.
  - c. litigation, when the related organization is a defendant in a suit and if the litigation could have an adverse effect on the bank (from SEC Form 10-K or another source)
  - d. each interlocking officer and/or director relationship as reflected by the information obtained in step 4. Determine
    - whether fees or salaries are excessive for duties performed and
    - if management devotes adequate time to its responsibilities.
10. In accordance with Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks,
    - a. obtain lists of loans to executive officers and business interests of directors, executive officers, and principal shareholders from the examiner assigned to duties and responsibilities of directors;
    - b. determine the accuracy and completeness of the list as it concerns related organizations by comparing it with information obtained from management and other examiners; and
    - c. investigate to determine undisclosed affiliate relationships if there are several directors or officers who have a common interest in the same entity by
      - obtaining a listing of all directors for the entity that are suspected of maintaining an affiliate relationship,
      - reviewing authorizing signatures on corporate resolutions to borrow, and
      - reviewing signatory authorities on deposit signature cards.
  11. If the bank engaged in an impermissible nonbank activity, determine whether it has divested itself of that activity.
  12. If the bank is a subsidiary of a holding company and the parent has sold commercial paper and funded bank loans with the proceeds, obtain or prepare the following schedules and forward them to the examiner assigned to funds management:
    - a. the amount and maturities of commercial paper outstanding and
    - b. the amount and maturity of the assets the commercial paper supports
  13. If the bank is a subsidiary of a holding company and if the parent has sold long-term debt and passed the proceeds down to the bank in the form of equity, obtain or prepare the following schedules and forward them to the examiner assigned to make an assessment of capital adequacy, including dividends:
    - a. the amount, maturity, and repayment terms of long-term debt sold
    - b. the amount of equity capital passed to the bank
    - c. the expected minimum dividend payment required by the bank to service the debt of the parent
  14. From the results of previous steps and discussion with management, determine if there are any anticipated changes in the relationship between the bank and its related organizations that may possibly have adverse effects on the affairs and soundness of the bank.
  15. On the basis of the above steps, determine the propriety of the carrying value and nature of the relationship between the bank and its related organizations and the effect of that relationship on the affairs and soundness of the bank.
  16. If, in the performance of the above procedures, the full nature and extent of interaction between the bank and its related organizations cannot be determined, and the examination or inspection reports of its functional regulators have been obtained and thoroughly reviewed, consider whether it will be necessary to perform an in-depth examination of certain of its related organizations. Perform the appropriate procedures found in step 19, and develop additional specific procedures based on the type and scope of activities being conducted.
  17. The following procedures should be considered when an in-depth examination of a bank's nonbank subsidiaries is deemed appropriate:
    - a. Review and analyze the liability structure of the nonbank subsidiaries by
      - reviewing and appraising any funding agreements with the parent bank;
      - reviewing all arrangements whereby the bank purchases assets on a nonre-

- course basis pursuant to 12 CFR 223.42(k);
- reviewing and appraising any funding agreements with (including guarantees), and debt instruments issued to, outside creditors; and
  - reviewing agreements with third parties involving the outright purchase of assets to determine liability for the repurchase of assets or any other contingent liabilities.
- b. Analyze the cash flows, earnings, and tax policies of the nonbank subsidiaries. Prepare cash-flow analyses for the previous three fiscal years and compare current year-to-date with previous year-to-date
- c. Review and evaluate capital adequacy by
- relating the consolidated classified assets of the subsidiaries against the consolidated net worth, or by relating classifieds proportionately to the parent's investment in, and advances to, each subsidiary;
  - commenting on the overall capital structure of both the parent bank and specific nonbank subsidiaries, as warranted; and
  - discussing the adequacy of capital with management, and noting management's future plans to raise capital.
- d. Review and evaluate management and control policies by
- reviewing board meeting minutes of the parent corporation and assessing director interest in, and awareness of, subsidiaries;
  - reviewing and evaluating corporate management's internal audit procedures for those policies;
  - reviewing "management letters" from certified public accountants about those internal controls; and
  - reviewing shareholder records, noting significant concentrations, and, when officers or directors are involved, noting any undue influence with regard to policies, practices, and procedures.
- e. Review management's future operating plan for the subsidiary company by
- analyzing the subsidiary's earnings and capital projections for one and five years;
  - obtaining underlying assumptions for
    - return on assets,
    - dividend retention rate,
    - asset growth rate, and
    - capital growth rate; and
  - comparing projections against past operating performance and commenting on the plan.
18. Discuss findings and conclusions reached in the examination of any nonbank subsidiary with the management of that entity. Prepare comments for the examination report.
19. Prepare, in appropriate report form, and discuss with appropriate bank management the following:
- a. the adequacy of written policies on related organizations
  - b. the manner in which bank officers are operating in conformance with established policy
  - c. violations of law or regulations
  - d. the impropriety of any transaction between the related organization and the bank
  - e. loans to, or investments in, related organizations that the examiner questions for any reason, such as their quality, carrying value, or ultimate collection
  - f. litigation, commitments, contingent liabilities, or current or anticipated changes between the bank and its related organizations that may have adverse effects on the affairs and soundness of the bank
  - g. interlocking officer or director relationships that are detrimental to the bank under examination or to any of its related organizations
  - h. any other information that will communicate the condition of the related organization and the nature and effect of the relationship between the related organization and the bank under examination
  - i. recommended corrective action when policies, practices, or procedures are deficient
20. Consolidate information in the operating subsidiary report (or reports) for inclusion in the report of examination.
21. Consolidate financial information and any other comments concerning related organizations for inclusion, when appropriate, in the report of examination.
22. If material changes have occurred in related organizations since the most recent examination of the bank, and if the changes may have a substantial impact on the bank, this

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- communicate this information by separate memorandum to the responsible supervising Federal Reserve Bank.
23. Update the workpapers with any information that will facilitate future examinations.

# Bank-Related Organizations

## Internal Control Questionnaire

Effective date April 2010

## Section 4052.4

Review the bank's internal controls, policies, practices, and procedures concerning related organizations. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

### POLICIES AND OBJECTIVES

1. Does the bank have written guidelines for the expansion of services through the formation or acquisition of related organizations?
2. Are established objectives and policies adhered to?
  - a. Is there an overall lending policy that would bring banking- and nonbanking-related organizations under a common set of controls?
  - b. Are bank officials an integral part of subsidiary or related-company management?
  - c. Can operating procedures be monitored from available internal or external audit reports?
3. Are periodic independent reviews performed to assess bank management's objectives and policies on the current status of their association with the related organizations?
4. Does bank management have an active role in the related organizations' audit committees, or does management retain the right to examine the companies' records, including the right to receive third-party letters from the external auditors?
5. Are policies and procedures such that the effect on the bank's liquidity is monitored when commercial paper or other proceeds are used to fund bank loans?

### RECORDS

1. Are records maintained for the companies in which the bank has a capital investment, including foreign companies, so that a determination can be made of the extent of bank control, quality of assets, profitability of the

company, legality of operations, and compliance with the investment limitations of Regulation K? (See Regulation K, sections 211.8 and 211.9.)

2. Does the bank maintain current records on the form and status of each related organization (such a list should include name, location, nature of business, manner of affiliation, relationship with bank, amount of loans, investments in and other extensions of credit, security pledged, obligations of any affiliate that is used as collateral security for advances made to others, commitments, and litigation)?
3. Does the bank maintain a copy of all internal or external audit reports, including management letters and responses, of the subsidiary or related company?
4. In the case of registered bank holding companies and nonbank affiliates arising through the holding company relationship, are copies of the Federal Reserve's inspection reports and forms 10-Q, 10-K, 8-K, FR Y-6, and FR Y-8 available for review?
5. In the case of Edge Act and agreement corporations and foreign subsidiaries, are copies of Federal Reserve examination reports and foreign regulatory reports available for review?
6. Do credit files of foreign subsidiaries include information regarding a particular country's cultural and legal influences on banking activities, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, fiscal policy, political goals, and risk of expropriation?
7. Are adequate records maintained to determine compliance with the investment provisions of Regulation K, including information on the type of investment (equity, binding commitments, capital contributions, subordinated debt), the dollar amount of the investment, the percentage of ownership, the activities conducted by the company, the legal authority for such activities, and whether the investment was made under Regulation K's general-consent, prior-notice, or specific-consent procedures? (See Regulation K, sections 211.8 and 211.9.)
8. Is the carrying value of all subsidiaries and



related companies accounted for on the equity basis and adjusted, at least quarterly, to reflect the reporting bank's cumulative share of the company's earnings or losses?

9. Was an objective review performed of the benefits, or the quality and fair value of assets, received from the bank's related organizations as compared to the bank's costs incurred for providing its services or assets?
10. Are money transfers between the bank and any related organization adequately documented to justify the equity of the transaction?

## CONCLUSION

1. Is the foregoing information considered an adequate basis for evaluating internal controls, that is, there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Banking organizations increasingly rely on information technology (IT) to conduct their operations and manage risks. The use of IT can have important implications for a banking organization's financial condition, risk profile, and operating performance and should be incorporated into the safety-and-soundness assessment of each organization. As a result, all safety-and-soundness examinations (or examination cycles) conducted by the Federal Reserve should include an assessment and evaluation of IT risks and risk management. Further information about banks' IT activities and examination methodology can be found in the *FFIEC Information Technology Examination Handbook* (the *IT Handbook*) and in supervisory guidance issued by the Federal Reserve and the other federal banking agencies.

### ASSESSING INFORMATION TECHNOLOGY IN THE RISK-FOCUSED SUPERVISORY FRAMEWORK

The risk-focused supervisory process is evolving to adapt to the changing role of IT in banking organizations, with greater emphasis on an assessment of IT's effect on an organization's safety and soundness. Accordingly, examiners should explicitly consider IT when developing risk assessments and supervisory plans. Examiners should use appropriate judgment in determining the level of review, given the characteristics, size, and business activities of the organization. Moreover, to determine the scope of supervisory activities, close coordination is needed between general safety-and-soundness examiners and IT specialists during the risk-assessment and planning phase, as well as during on-site examinations. Given the variability of IT environments, the level of technical expertise needed for a particular examination will vary across institutions and should be identified during the planning phase of the examination. In general, examiners should accomplish the following goals during a risk-focused examination:

- Develop a broad understanding of the organization's approach to, and strategy and structure for, IT activities within and across business lines. Determine also the role and

importance of IT to the organization and any unique characteristics or issues.

- Incorporate an analysis of IT activities into risk assessments, supervisory plans, and scope memoranda. An organization's IT systems should be considered in relation to the size, activities, and complexity of the organization, as well as the degree of reliance on these systems across particular business lines. Although IT concerns would clearly affect an institution's operational risk profile, IT also can affect other business risks (such as credit, market, liquidity, legal, and reputational risk), depending upon the specific circumstances, and should be incorporated into these assessments as appropriate.
- Assess the organization's critical systems, that is, those that support its major business activities, and the degree of reliance those activities have on IT systems. The level of review should be sufficient to determine that the systems are delivering the services necessary for the organization to conduct its business in a safe and sound manner.
- Determine whether the board of directors and senior management are adequately identifying, measuring, monitoring, and controlling the significant risks associated with IT for the overall organization and its major business activities.

### INTERAGENCY GUIDELINES ESTABLISHING INFORMATION SECURITY STANDARDS

The federal banking agencies jointly issued interagency guidelines establishing information security standards (the information security standards), which became effective July 1, 2001.<sup>1</sup> (See appendix B of this section.) The Board of Governors of the Federal Reserve System approved amendments to the standards on December 16, 2004 (effective July 1, 2005). The amended information security standards implement sections 501 and 505 of the Gramm-Leach-Bliley Act (15 USC 6801 and 6805) and section 216 of the Fair and Accurate Credit Transac-

1. See 66 *Fed. Reg.* 8616–8641 (February 1, 2001) and 69 *Fed. Reg.* 77610–77612 (December 28, 2004); Regulation H, 12 CFR 208, appendix D-2; Regulation K, 12 CFR 211.9 and 211.24; and Regulation Y, 12 CFR 225, appendix F.

tions Act of 2003 (15 USC 1681w). The Gramm-Leach-Bliley Act requires the agencies to establish financial-institution information security standards for administrative, technical, and physical safeguards for customer records and information. (See SR-01-15.)

Under the information security standards, institutions must establish an effective *written* information security program to assess and control risks to customer information. An institution's information security program should be appropriate to its size and complexity and to the nature and scope of its operations. The board of directors should oversee the institution's development, implementation, and maintenance of the information security program and also approve written information security policies and programs.

The information security program should include administrative, technical, and physical safeguards appropriate to the size and complexity of the bank and the nature and scope of its activities. The program should be designed to ensure the security and confidentiality of customer information;<sup>2</sup> protect against anticipated threats or hazards to the security or integrity of such information; protect against unauthorized access to, or use of, such information that could result in substantial harm or inconvenience to any customer;<sup>3</sup> and ensure the proper disposal of customer information and consumer information. Each institution must assess risks to customer information and implement appropriate policies, procedures, training, and testing to manage and control these risks. Institutions must also report annually to the board of directors or a committee of the board of directors.

The information security standards outline specific security measures that banking organizations should consider in implementing a security program based on the size and complexity of their operations. Training and testing are also

critical components of an effective information security program. Financial institutions are required to oversee their service-provider arrangements in order to (1) protect the security of customer information maintained or processed by service providers; (2) ensure that its service providers properly dispose of customer and consumer information; and (3) where warranted, monitor its service providers to confirm that they have satisfied their contractual obligations.

The Federal Reserve recognizes that banking organizations are highly sensitive to the importance of safeguarding customer information and the need to maintain effective information security programs. Existing examination procedures and supervisory processes already address information security. As a result, most banking organizations may not need to implement any new controls and procedures.

Examiners should assess compliance with the standards during each safety-and-soundness examination, which may include targeted reviews of information technology. Ongoing compliance with the standards should be monitored, as needed, during the risk-focused examination process. Material instances of noncompliance should be noted in the examination report.

The information security standards apply to customer information maintained by, or on behalf of, state member banks and bank holding companies and the nonbank subsidiaries of each.<sup>4</sup> The information security standards also address standards for the proper disposal of consumer information, pursuant to sections 621 and 628 of the Fair Credit Reporting Act (15 USC 1681s and 1681w). To address the risks associated with identity theft, a financial institution is generally required to develop, implement, and maintain, as part of its existing information security program, appropriate measures to properly dispose of consumer information derived from consumer reports.

*Consumer information* is defined as any record about an individual, whether in paper, electronic, or other form, that is a consumer report or is derived from a consumer report and that is maintained or otherwise possessed by or on

2. *Customer information* is defined to include any record, whether in paper, electronic, or other form, containing *non-public personal information*, as defined in Regulation P, about a financial institution's customer that is maintained by, or on behalf of, the institution.

3. A *customer* is defined in the same manner as in Regulation P: a consumer who has established a continuing relationship with an institution under which the institution provides one or more financial products or services to the consumer to be used primarily for personal, family, or household purposes. The definition of customer does not include a business, nor does it include a consumer who has not established an ongoing relationship with the financial institution.

4. The information security standards do not apply to brokers, dealers, investment companies, and investment advisers, or to persons providing insurance under the applicable state insurance authority of the state in which the person is domiciled. The appropriate federal agency or state insurance authority regulates insurance entities under sections 501 and 505 of the GLB Act.

behalf of the bank for a business purpose. Consumer information also means a compilation of such records.

The following are examples of consumer information:

- a consumer report that a bank obtains
- information from a consumer report that the bank obtains from its affiliate after the consumer has been given a notice and has elected not to opt out of that sharing
- information from a consumer report that the bank obtains about an individual who applies for but does not receive a loan, including any loan sought by an individual for a business purpose
- information from a consumer report that the bank obtains about an individual who guarantees a loan (including a loan to a business entity)
- information from a consumer report that the bank obtains about an employee or prospective employee

Consumer information does not include any record that does not personally identify an individual, nor does it include the following:

- aggregate information, such as the mean score, derived from a group of consumer reports
- blind data, such as payment history on accounts that are not personally identifiable, that may be used for developing credit scoring-models or for other purposes
- information from a consumer report that the bank obtains about an individual who applies for but does not receive a loan, including any loan sought by an individual for a business purpose
- information from a consumer report that the bank obtains about an individual who guarantees a loan (including a loan to a business entity)
- information from a consumer report that the bank obtains about an employee or prospective employee

An institution or banking organization is not required to implement a *uniform* information security program. For example, a bank holding company may include subsidiaries within the scope of its information security program, or the subsidiaries may implement separate information security programs. The institution or bank

holding company is expected, however, to coordinate all the elements of its information security program.

Institutions must exercise due diligence when selecting service providers, including reviewing the service provider's information security program or the measures the service provider uses to protect the institution's customer information.<sup>5</sup> All contracts must require that the service provider implement appropriate measures designed to meet the objectives of the standards. Institutions must also conduct ongoing oversight to confirm that the service provider maintains appropriate security measures. An institution's methods for overseeing its service-provider arrangements may differ depending on the type of services or service provider or the level of risk. For example, if a service provider is subject to regulations or a code of conduct that imposes a duty to protect customer information consistent with the objectives of the standards, the institution may consider that duty in exercising its due diligence and oversight of the service provider. In situations where a service provider hires a subservicer (or subcontractor), the subservicer would not be considered a "service provider" under the guidelines.

## Response Programs for Unauthorized Access to Customer Information and Customer Notice

Response programs specify actions that are to be taken when a financial institution suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies.<sup>6</sup> A response program is the principal means for a financial institution to protect against unauthorized "use" of customer information that could lead to "substantial harm or inconvenience" to the institution's customer. For example, customer notification is an important tool that enables a customer to take steps to prevent identity theft, such as by arranging to have a fraud alert placed in his or her credit file.

The measures enumerated in the information security standards include "response programs

5. A *service provider* is deemed to be a person or entity that maintains, processes, or is otherwise permitted access to customer information through its provision of services directly to the bank.

6. See the information security standards, 12 CFR 208, appendix D-2, section III.C.

that specify actions to be taken when the bank suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies.”<sup>7</sup> Prompt action by both the institution and the customer following the unauthorized access to customer information is crucial to limiting identity theft. As a result, every financial institution should develop and implement a response program appropriate to its size and complexity and to the nature and scope of its activities. The program should be designed to address incidents of unauthorized access to customer information.

The Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice<sup>8</sup> (the guidance) interprets section 501(b) of the Gramm-Leach-Bliley Act (the GLB Act) and the information security standards.<sup>9</sup> The guidance describes the response programs, including customer notification procedures, that a financial institution should develop and implement to address unauthorized access to or use of customer information that could result in substantial harm or inconvenience to a customer.

When evaluating the adequacy of an institution’s information security program that is required by the information security standards, examiners are to consider whether the institution has developed and implemented a response program equivalent to the guidance. At a minimum, an institution’s response program should contain procedures for (1) assessing the nature and scope of an incident, and identifying what customer information systems and types of customer information have been accessed or misused; (2) notifying its primary federal regulator as soon as possible when the institution becomes aware of an incident involving unauthorized access to or use of *sensitive* customer information, as defined later in the guidance; (3) immediately notifying law enforcement in situations involving federal criminal violations requiring immediate attention; (4) taking appropriate steps

to contain and control the incident to prevent further unauthorized access to or use of customer information, such as by monitoring, freezing, or closing affected accounts, while preserving records and other evidence; and (5) notifying customers when warranted.

The guidance does not apply to a financial institution’s foreign offices, branches, or affiliates. However, a financial institution subject to the information security standards is responsible for the security of its customer information, whether the information is maintained within or outside of the United States, such as by a service provider located outside of the United States.

The guidance also applies to *customer information*, meaning any record containing “non-public personal information” about a financial institution’s customer, whether the information is maintained in paper, electronic, or other form, *that is maintained by or on behalf of the institution*.<sup>10</sup> (See the Board’s privacy rule, Regulation P, at section 216.3(n)(2) (12 CFR 216.3(n)(2).) Consequently, the guidance applies only to information that is within the control of the institution and its service providers. The guidance would not apply to information directly disclosed by a customer to a third party, for example, through a fraudulent web site.

The guidance also does not apply to information involving business or commercial accounts. Instead, the guidance applies to nonpublic personal information about a *customer*, as that term is used in the information security standards, namely, a consumer who obtains a financial product or service from a financial institution to be used primarily for personal, family, or household purposes and who has a continuing relationship with the institution.<sup>11</sup>

### *Response Programs*

Financial institutions should take preventative measures to safeguard customer information against attempts to gain unauthorized access to the information. For example, financial institutions should place access controls on customer information systems and conduct background checks for employees who are authorized to

7. See the information security standards, section III.C.1.g.

8. The guidance was jointly issued on March 23, 2005 (effective March 29, 2005), by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

9. See 12 CFR 208, appendix D-2, and 12 CFR 225, appendix F. The Interagency Guidelines Establishing Information Security Standards were formerly known as the Interagency Guidelines Establishing Standards for Safeguarding Customer Information.

10. See the information security standards, 12 CFR 208, appendix D-2, section I.C.2.e.

11. See the information security standards, 12 CFR 208, appendix D-2, section I.C.2.d., and the Board’s privacy rule (Regulation P), section 216.3(h) (12 CFR 216.3(h)).

access customer information.<sup>12</sup> However, every financial institution should also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems<sup>13</sup> that occur nonetheless. A response program should be a key part of an institution's information security program.<sup>14</sup> The program should be appropriate to the size and complexity of the institution and the nature and scope of its activities.

In addition, each institution should be able to address incidents of unauthorized access to customer information in customer information systems maintained by its domestic and foreign service providers. Therefore, consistent with the obligations in the information security standards that relate to these arrangements, and with existing guidance on this topic issued by the agencies,<sup>15</sup> an institution's contract with its service provider should require the service provider to take appropriate actions to address incidents of unauthorized access to the financial institution's customer information, including notification to the institution as soon as possible of any such incident, to enable the institution to expeditiously implement its response program.

*Components of a response program.* At a minimum, an institution's response program should contain procedures for the following:

- assessing the nature and scope of an incident, and identifying what customer information systems and types of customer information have been accessed or misused
- notifying its primary federal regulator as soon as possible when the institution becomes aware of an incident involving unauthorized access

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12. Institutions should also conduct background checks of employees to ensure that the institution does not violate 12 USC 1829, which prohibits an institution from hiring an individual convicted of certain criminal offenses or who is subject to a prohibition order under 12 USC 1818(e)(6).

13. Under the information security standards, an institution's *customer information systems* consist of all the methods used to access, collect, store, use, transmit, protect, or dispose of customer information, including the systems maintained by its service providers. See the information security standards, 12 CFR 208, appendix D-2, section I.C.2.f.

14. See SR-97-32, "Sound Practices Guidance for Information Security for Networks," for additional guidance on preventing, detecting, and responding to intrusions into financial institution computer systems.

15. See SR-00-04, "Outsourcing of Information and Transaction Processing," and the subsection "Outsourcing Information Technology."

to or use of *sensitive* customer information, as defined below

- consistent with the Suspicious Activity Report by Depository Institutions (SAR-DI) regulations,<sup>16</sup> notifying appropriate law enforcement authorities, in addition to filing a timely SAR-DI form in situations involving federal criminal violations requiring immediate attention, such as when a reportable violation is ongoing
- taking appropriate steps to contain and control the incident to prevent further unauthorized access to or use of customer information, for example, by monitoring, freezing, or closing affected accounts, while preserving records and other evidence
- notifying customers when warranted

Where an incident of unauthorized access to customer information involves customer information systems maintained by an institution's service providers, it is the responsibility of the financial institution to notify the institution's customers and regulator. However, an institution may authorize or contract with its service provider to notify the institution's customers or regulator on its behalf.

### *Customer Notice*

Financial institutions have an affirmative duty to protect their customers' information against unauthorized access or use. Notifying customers of a security incident involving the unauthorized access or use of the customer's information in accordance with the standard set forth below is a key part of that duty. Timely notification of customers is important to managing an institution's reputation risk. Effective notice also may reduce an institution's legal risk, assist in maintaining good customer relations, and enable the institution's customers to take steps to protect themselves against the consequences of identity theft. When customer notification is warranted, an institution may not forgo notifying its customers of an incident because the institution

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16. An institution's obligation to file a SAR-DI form is set out in SAR-DI form regulations and supervisory guidance. See 12 CFR 208.62 (state member banks); 12 CFR 211.5(k) (Edge and agreement corporations); 12 CFR 211.24(f) (uninsured state branches and agencies of foreign banks); and 12 CFR 225.4(f) (bank holding companies and their nonbank subsidiaries). See SR-07-2 and its attachments and also SR-01-11, "Identity Theft and Pretext Calling."

believes that it may be potentially embarrassed or inconvenienced by doing so.

*Standard for providing notice.* When a financial institution becomes aware of an incident of unauthorized access to sensitive customer information, the institution should conduct a reasonable investigation to promptly determine the likelihood that the information has been or will be misused. If the institution determines that misuse of its information about a customer has occurred or is reasonably possible, it should notify the affected customer as soon as possible. Customer notice may be delayed if an appropriate law enforcement agency determines that notification will interfere with a criminal investigation and provides the institution with a written request for the delay. However, the institution should notify its customers as soon as notification will no longer interfere with the investigation.

*Sensitive customer information.* Under the information security standards, an institution must protect against unauthorized access to or use of customer information that could result in substantial harm or inconvenience to any customer. Substantial harm or inconvenience is most likely to result from improper access to *sensitive customer information* because this type of information is most likely to be misused, as in the commission of identity theft. For purposes of the guidance, *sensitive customer information* means a customer's name, address, or telephone number, in conjunction with the customer's Social Security number, driver's license number, account number, credit or debit card number, or a personal identification number or password that would permit access to the customer's account. Sensitive customer information also includes any combination of components of customer information that would allow someone to log onto or access the customer's account, such as a user name and password or a password and an account number.

*Affected customers.* If a financial institution, on the basis of its investigation, can determine from its logs or other data precisely which customers' information has been improperly accessed, it may limit notification to those customers for whom the institution determines that misuse of their information has occurred or is reasonably possible. However, there may be situations in which the institution determines that a group of

files has been accessed improperly but is unable to identify which specific customers' information has been accessed. If the circumstances of the unauthorized access lead the institution to determine that misuse of the information is reasonably possible, it should notify all customers in the group.

*Content of customer notice.* Customer notice should be given in a clear and conspicuous manner. The notice should describe the incident in general terms and the type of customer information that was the subject of unauthorized access or use. It should also generally describe what the institution has done to protect the customers' information from further unauthorized access. In addition, it should include a telephone number that customers can call for further information and assistance.<sup>17</sup> The notice also should remind customers of the need to remain vigilant over the next 12 to 24 months, and to promptly report incidents of suspected identity theft to the institution. The notice should include the following additional items, when appropriate:

- a recommendation that the customer review account statements and immediately report any suspicious activity to the institution
- a description of fraud alerts and an explanation of how the customer may place a fraud alert in the customer's consumer reports to put the customer's creditors on notice that the customer may be a victim of fraud
- a recommendation that the customer periodically obtain credit reports from each nationwide credit reporting agency and have information relating to fraudulent transactions deleted
- an explanation of how the customer may obtain a credit report free of charge
- information about the availability of the FTC's online guidance regarding steps a consumer can take to protect against identity theft (The notice should encourage the customer to report any incidents of identity theft to the FTC and should provide the FTC's web site address and toll-free telephone number that customers may use to obtain the identity theft guidance

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17. The institution should, therefore, ensure that it has reasonable policies and procedures in place, including trained personnel, to respond appropriately to customer inquiries and requests for assistance.

and to report suspected incidents of identity theft.<sup>18</sup>

Financial institutions are encouraged to notify the nationwide consumer reporting agencies before sending notices to a large number of customers when those notices include contact information for the reporting agencies.

*Delivery of customer notice.* Customer notice should be delivered in any manner designed to ensure that a customer can reasonably be expected to receive it. For example, the institution may choose to contact all affected customers by telephone, by mail, or by electronic mail, in the case of customers for whom it has a valid e-mail address and who have agreed to receive communications electronically.

## IDENTITY THEFT RED FLAGS PROGRAM

The federal financial institution regulatory agencies<sup>18a</sup> and the Federal Trade Commission (FTC) have issued joint regulations and guidelines on the *detection, prevention, and mitigation* of identity theft in connection with opening of certain accounts or maintaining certain existing accounts in response to the Fair and Accurate Credit Transactions Act of 2003 (The FACT Act).<sup>18b</sup> The regulations require (debit and credit) card issuers to validate notifications of changes of address under certain circumstances. The joint rules also provide guidelines regarding reasonable policies and procedures that a user of consumer reports must employ when a consumer reporting agency sends the user a notice of address discrepancy. Financial institutions or creditors<sup>18c</sup> that offer or maintain one or more

“covered accounts” must develop and implement a written Identity Theft Prevention Program (Program).<sup>18d</sup> A Program is to be designed to detect, prevent, and mitigate identity theft in connection with the opening of a covered account or any existing covered account. The Program must be tailored to the entity’s size, complexity, and the nature and scope of its operations and activities.

The Board’s approval of the rule and guidelines was on October 16, 2007. The effective date for the joint final rules and guidelines is January 1, 2008. The mandatory compliance date for the rules is November 1, 2008. See section 222 of the Board’s Regulation V—Fair Credit Reporting (12 CFR 222) and 72 *Fed. Reg.* 63718- 63775, November 9, 2007.

This section incorporates certain financial institution safety and soundness provisions of the rule (Regulation V and its guidelines (Appendix J)). See also the October 10, 2008, Federal Reserve Board letter (SR-08-7/CA-08-10) and its interagency attachments.

## Risk Assessment

Prior to the development of the Program, a financial institution must initially and then periodically conduct a risk assessment to determine whether it offers or maintains covered accounts. It must take into consideration: (1) the methods it provides to open its accounts, (2) the methods it provides to access accounts, and (3) its previous experiences with identity theft. If the financial institution has covered accounts, it must evaluate its potential vulnerability to identity theft. The institution should also consider whether a reasonably foreseeable risk of identity theft may exist in connection with the accounts it offers or maintains and those that may be opened or accessed remotely, through methods that do not require face-to-face contact, such as through the internet or telephone. Financial institutions that offer or maintain business

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18. The FTC website for the ID theft brochure and the FTC hotline phone number are [www.ftc.gov/bcp/edu/microsites/idtheft/](http://www.ftc.gov/bcp/edu/microsites/idtheft/) and 1-877-IDTHEFT. The institution may also refer customers to any materials developed pursuant to section 151(b) of the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act) (educational materials developed by the FTC to teach the public how to prevent identity theft).

18a. The Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA).

18b. Section 111 of the FACT Act defines “identity theft” as “a fraud committed or attempted using the identifying information of another person.”

18c. The term financial institution should be interpreted to

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mean a “financial institution or creditors” with regard to the Red Flags Program joint regulations and the accompanying interagency guidance.

18d. “Covered accounts” are (1) accounts that a financial institution offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions and (2) any other account that the financial institution offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution from identity theft.



accounts that have been the target of identity theft should factor those experiences with identity theft into their determination.

If the financial institution determines that it has covered accounts, the risk assessment will enable it to identify which of its accounts the Program must address. If a financial institution initially determines that it does not have covered accounts, it must periodically reassess whether it must develop and implement a Program in light of changes in the accounts that it offers or maintains.

## Elements of the Program

The elements of the actual Program will vary depending on the size and complexity of the financial institution. A financial institution that determines that it is required to establish and maintain an Identity Theft Prevention Program must (1) identify relevant Red Flags for its covered accounts, (2) detect and respond to the Red Flags that have been incorporated into its Program, and (3) respond appropriately to the detected Red Flags. The Red Flags are patterns, practices, or specific activities that indicate the possible existence of identity theft or the potential to lead to identity theft. A financial institution must ensure that its Program is updated periodically to address the changing risks associated with its customers and their accounts and to the safety and soundness of the financial institution from identity theft.

## Guidelines

Each financial institution that is required to implement a written Program must consider the Guidelines for Identity Theft Detection, Prevention, and Mitigation's in Appendix J (12 CFR 222, Appendix J of the rule) (the Guidelines) and include those guidelines that are appropriate in its Program. Section I of the Guidelines, "The Program," discusses a Program's design that may include, as appropriate, existing policies, procedures, and arrangements that control foreseeable risks to the institution's customers or to the safety and soundness of the financial institution from identity theft.

## Identification of Red Flags

A financial institution should incorporate relevant Red Flags into the Program from sources such as (1) incidents of identity theft that it has experienced, (2) methods of identity theft that have been identified as reflecting changes in identity theft risks, and (3) applicable supervisory guidance.

## Categories of Red Flags

Section II of the Guidelines, "Categories of Red Flags," provides some guidance in identifying relevant Red Flags. A financial institution should include, as appropriate,<sup>18e</sup>

- alerts, notifications, or other warnings received from consumer reporting agencies or service providers, such as fraud detection services
- the presentation of suspicious documents
- the presentation of suspicious personal identifying information, such as a suspicious address change
- the unusual use of, or other suspicious activity related to, a covered account
- a notice received from customers, victims of identity theft, law enforcement authorities, or other persons regarding possible identity theft in connection with covered accounts held by the financial institution

The above categories do not represent a comprehensive list of all types of Red Flags that may indicate the possibility of identity theft. Institutions must also consider specific business lines and any previous exposures to identity theft. No specific Red Flag is mandatory for all financial institutions. Rather, the Program should follow the risk-based, nonprescriptive approach regarding the identification of Red Flags.

## Detect the Program's Red Flags

In accordance with Section III of the Guidelines, each financial institution's Program should address the detection of Red Flags in connection with the opening of covered accounts and existing covered accounts. A financial institution is required to detect, prevent, and mitigate identity

<sup>18e</sup> Examples of Red Flags from each of these categories are appended as supplement A to appendix J.

theft in connection with such accounts. The policies and procedures regarding opening a covered account subject to the Program should explain how an institution could identify information about, and verify the identity of, a person opening an account.<sup>18f</sup> In the case of existing covered accounts, institutions could authenticate customers, monitor transactions, and verify the validity of change of address requests.

### *Respond Appropriately to any Detected Red Flags*

A financial institution should consider precursors to identity theft to stop identity theft before it occurs. Section IV of the Guidelines, “Prevention and Mitigation,” states that an institution’s procedures should provide for appropriate responses to Red Flags that it has detected that are commensurate with the degree of risk posed. When determining an appropriate response, the institution should consider aggravating factors that may heighten its risk of identity theft. Such factors may include (1) a data security incident that results in unauthorized disclosures of non-public personal information (NPPI), (2) records the financial institution holds or that are held by another creditor or third party, or (3) notice that the institution’s customer has provided information related to its covered account to someone fraudulently claiming to represent the financial institution or creditor or to a fraudulent website. Appropriate responses may include the following: (1) monitoring a covered account for evidence of identity theft; (2) contacting the customer; (3) changing any passwords, security codes, or other security devices that permit access to a secured account; (4) reopening a covered account with a new account number; (5) not opening a new covered account; (6) closing an existing covered account; (7) not attempting to collect on a covered account or not selling a covered account to a debt collector; (8) notifying law enforcement; or (9) determining that no response is warranted under the particular circumstances.

### *Periodically Updating the Program’s Relevant Red Flags*

Section V of the Guidelines, “Updating the

<sup>18f</sup>. 31 USC 5318(l) (31 CFR 103.121)

Program,” states that a financial institution should periodically update its Program (including its relevant Red Flags) to reflect any changes in risks to its customers or to the safety and soundness of the institution from identity theft, based on (but not limited to) factors such as

- the experiences of the financial institution with identity theft;
- changes in methods of identity theft;
- changes in methods to detect, prevent, and mitigate identity theft;
- changes in the types of accounts that the financial institution offers or maintains; and
- changes in the financial institution’s structure, including its mergers, acquisitions, joint ventures, and any business arrangements, such as alliances and service provider arrangements.

### *Administration of Program*

A financial institution that is required to implement a Program must provide for the continued oversight and administration of its Program. The following are the steps that are needed in the administration of a Red Flags Program:

1. *Obtain approval from either the institution’s board of directors or any appropriate committee of the board of directors of the initial written Program;*
2. *Involve either the board of directors, a designated committee of the board of directors, or a designated senior-management-level employee in the oversight, development, implementation, and administration of the Program. This includes*
  - assigning specific responsibility for the Program’s implementation,
  - reviewing reports prepared by staff regarding the institution’s compliance (the reports should be prepared at least annually), and
  - reviewing material changes to the Program as necessary to address changing identity theft risks.
3. *Train staff.* The financial institution must train relevant staff to effectively implement and monitor the Program. Training should be provided as changes are made to the financial institution’s Program based on its periodic risk assessment.
4. *Exercise appropriate and effective oversight*

*of service provider arrangements.* Section VI of the Guidelines, “Methods for Administering the Program,” indicates a financial institution is ultimately responsible for complying with the rules and guidelines for outsourcing an activity to a third-party service provider. Whenever a financial institution engages a service provider to perform an activity in connection with one or more covered accounts, the institution should ensure that the activity of the service provider is conducted in accordance with reasonable policies and procedures designed to detect, prevent, and mitigate the risk of identity theft. With regard to the institution’s oversight of its Program, periodic reports from service providers are to be issued on the Program’s development, implementation, and administration.

## IT EXAMINATION FREQUENCY AND SCOPE

All safety-and-soundness examinations (or examination cycles) of banking organizations conducted by the Federal Reserve should include an assessment and evaluation of IT risks and risk management. The scope of the IT assessment should generally be sufficient to assign a composite rating under the Uniform Rating System for Information Technology (URSIT). URSIT component ratings may be updated at the examiner’s discretion, based on the scope of the assessment. The scope would normally be based on factors such as—

- implementation of new systems or technologies since the last examination;
- significant changes in operations, such as mergers or systems conversions;
- new or modified outsourcing relationships for critical operations;
- targeted examinations of business lines whose internal controls or risk-management systems depend heavily on IT; and
- other potential problems or concerns that may have arisen since the last examination or the need to follow up on previous examination or audit issues.

Institutions that outsource core processing functions, although not traditionally subject to IT examinations, are exposed to IT-related risks. For

these institutions, some or all components of the URSIT rating may not be meaningful. In these cases, the assessment of IT activities may be incorporated directly into the safety-and-soundness rating for the institution, rather than through the assignment of an URSIT rating. The scope of the IT assessment for such institutions should evaluate the adequacy of the institution’s oversight of service providers for critical processing activities and should incorporate the results of any relevant supervisory reviews of these service providers. The assessment should also include reviews of any significant in-house activities, such as management information systems and local networks, and the implementation of new technologies, such as Internet banking. As noted above, the assessment of IT should be reflected in the overall safety-and-soundness examination report and in the appropriate components of the safety-and-soundness examination rating assigned to the institution, as well as in the associated risk-profile analysis. (See SR-00-3.)

Targeted IT examinations may be conducted more frequently, if deemed necessary, by the Reserve Bank. A composite URSIT rating should be assigned for targeted reviews when possible. In addition, institutions for which supervisory concerns have been raised (normally those rated URSIT 3, 4, or 5) should be subject to more frequent IT reviews, until such time as the Reserve Bank is satisfied that the deficiencies have been corrected.

## RISK ELEMENTS

To provide a common terminology and consistent approach for evaluating the adequacy of an organization’s IT, five IT elements are defined below. These elements may be used to evaluate the IT processes at the functional business level or for the organization as a whole and to determine the impact on the business risks outlined in SR-95-51, as well as their impact on the IT rating (URSIT) discussed below. (See SR-98-9.)

1. *Management processes.* Management processes encompass planning, investment, development, execution, and staffing of IT from a corporate-wide and business-specific perspective. Management processes over IT are effective when they are adequately and appropriately aligned with and support the

organization's mission and business objectives. Management processes include strategic planning; budgeting; management and reporting hierarchy; management succession; and a regular, independent review function. Examiners should determine if the IT strategy for the business activity or organization is consistent with the organization's mission and business objectives and whether the IT function has effective management processes to execute that strategy.

2. *Architecture.* Architecture refers to the underlying design of an automated information system and its individual components. The underlying design encompasses both physical and logical architecture, including operating environments, as well as the organization of data. The individual components refer to network communications, hardware, and software, which includes operating systems, communications software, database-management systems, programming languages, and desktop software. Effective architecture meets current and long-term organizational objectives, addresses capacity requirements to ensure that systems allow users to easily enter data at both normal and peak processing times, and provides satisfactory solutions to problems that arise when information is stored and processed in two or more systems that cannot be connected electronically. When assessing the adequacy of IT architecture, examiners should consider the ability of the current infrastructure to meet operating objectives, including the effective integration of systems and sources of data.
3. *Integrity.* Integrity refers to the reliability, accuracy, and completeness of information delivered to the end-user. Integrity risk could arise from insufficient controls over systems or data, which could adversely affect critical financial and customer information. Examiners should review and consider whether the organization relies on information system audits or independent reviews of applications to ensure the integrity of its systems. Examiners should review the reliability, accuracy, and completeness of information delivered in key business lines.
4. *Security.* Security risk is the risk of unauthorized disclosure or destruction of critical or sensitive information. To mitigate this risk, physical access and logical controls are generally provided to achieve a level of protec-

tion commensurate with the value of the information. Security risk is managed effectively when controls prevent unauthorized access, modification, destruction, or disclosure of sensitive information during creation, transmission, processing, maintenance, or storage. Examiners should ensure that operating procedures and controls are commensurate with the potential for and risks associated with security breaches, which may be either physical or electronic, inadvertent or intentional, internal or external.

5. *Availability.* Availability refers to the timely delivery of information and processes to end-users in support of business and decision-making processes and customer services. In assessing the management of availability risk, examiners should consider the capability of IT functions to provide information to the end-users from either primary or secondary sources, as well as consider the ability of back-up systems, as presented in contingency plans, to mitigate business disruption. Contingency plans should set out a process for an organization to restore or replace its information-processing resources; reconstruct its information assets; and resume its business activity from disruption caused by human error or intervention, natural disaster, or infrastructure failure (including loss of utilities and communication lines and the operational failure of hardware, software, and network communications).

## UNIFORM RATING SYSTEM FOR INFORMATION TECHNOLOGY

The Uniform Rating System for Information Technology (URSIT) is an interagency examination rating system adopted by the Federal Financial Institutions Examination Council (FFIEC) agencies to evaluate the IT activities of financial institutions. The rating system includes component- and composite-rating descriptions and the explicit identification of risks and assessment factors that examiners consider in

assigning component ratings. This rating system helps examiners assess risk and compile examination findings. However, the rating system should not drive the scope of an examination. In particular, not all assessment factors or component-rating areas are required to be assessed at each examination. Examiners should use the rating system to help evaluate the entity's overall risk exposure and risk-management performance and to determine the degree of supervisory attention believed necessary to ensure that weaknesses are addressed and that risk is properly managed. (See SR-99-8.)

The URSIT rating framework is based on a risk evaluation of four general areas: audit, management, development and acquisition, and support and delivery. These components are used to assess the overall IT functions within an organization and arrive at a composite URSIT rating. Examiners evaluate the areas identified within each component to assess the institution's ability to identify, measure, monitor, and control IT risks.

In adopting the URSIT rating system, the FFIEC recognized that management practices vary considerably among financial institutions depending on their size and sophistication, the nature and complexity of their business activities, and their risk profile. For less complex information systems environments, detailed or highly formalized systems and controls are not required to receive the higher composite and component ratings.

## URSIT Composite-Rating Definitions

Financial institutions rated URSIT composite 1 exhibit strong performance in every respect and generally have components rated 1 or 2. Weaknesses in IT functions are minor and are easily corrected during the normal course of business. Risk-management processes provide a comprehensive program to identify and monitor risk relative to the size, complexity, and risk profile of the entity. Strategic plans are well defined and fully integrated throughout the organization. This allows management to quickly adapt to the changing market, business, and technology needs of the entity. Management identifies weaknesses promptly and takes appropriate corrective action to resolve audit and regulatory concerns.

Financial institutions rated URSIT composite

2 exhibit safe and sound performance but may demonstrate modest weaknesses in operating performance, monitoring, management processes, or system development. Generally, senior management corrects weaknesses in the normal course of business. Risk-management processes adequately identify and monitor risk relative to the size, complexity, and risk profile of the entity. Strategic plans are defined but may require clarification, better coordination, or improved communication throughout the organization. As a result, management anticipates, but responds less quickly to changes in the market, business, and technological needs of the entity. Management normally identifies weaknesses and takes appropriate corrective action. However, greater reliance is placed on audit and regulatory intervention to identify and resolve concerns. While internal control weaknesses may exist, there are no significant supervisory concerns. As a result, supervisory action is informal and limited.

Financial institutions rated URSIT composite 3 exhibit some degree of supervisory concern due to a combination of weaknesses that may range from moderate to severe. If weaknesses persist, further deterioration in the condition and performance of the institution is likely. Risk-management processes may not effectively identify risks and may not be appropriate for the size, complexity, or risk profile of the entity. Strategic plans are vaguely defined and may not provide adequate direction for IT initiatives. As a result, management often has difficulty responding to changes in the business, market, and technological needs of the entity. Self-assessment practices are weak and generally reactive to audit and regulatory exceptions. Repeat concerns may exist, indicating that management may lack the ability or willingness to resolve concerns. While financial or operational failure is unlikely, increased supervision is necessary. Formal or informal supervisory action may be necessary to secure corrective action.

Financial institutions rated URSIT composite 4 operate in an unsafe and unsound environment that may impair the future viability of the entity. Operating weaknesses are indicative of serious managerial deficiencies. Risk-management processes inadequately identify and monitor risk, and practices are not appropriate given the size, complexity, and risk profile of the entity. Strategic plans are poorly defined and not coordinated or communicated throughout the organization. As a result, management and the board are not committed to, or may be incapable of,

ensuring that technological needs are met. Management does not perform self-assessments and demonstrates an inability or unwillingness to correct audit and regulatory concerns. Failure of the financial institution may be likely unless IT problems are remedied. Close supervisory attention is necessary and, in most cases, formal enforcement action is warranted.

Financial institutions rated URSIT composite 5 exhibit critically deficient operating performance and are in need of immediate remedial action. Operational problems and serious weaknesses may exist throughout the organization. Risk-management processes are severely deficient and provide management little or no perception of risk relative to the size, complexity, and risk profile of the entity. Strategic plans do not exist or are ineffective, and management and the board provide little or no direction for IT initiatives. As a result, management is unaware of or inattentive to the technological needs of the entity. Management is unwilling or incapable of correcting audit and regulatory concerns. Ongoing supervisory attention is necessary.

## URSIT Component Ratings

### *Audit*

Financial institutions and service providers are expected to provide independent assessments of their exposure to risks and of the quality of internal controls associated with the acquisition, implementation, and use of IT. Audit practices should address the IT risk exposures throughout the institution and the exposures of its service provider(s) in the areas of user and data center operations, client/server architecture, local and wide area networks, telecommunications, information security, electronic data interchange, systems development, and contingency planning. This rating should reflect the adequacy of the organization's overall IT audit program, including the internal and external auditor's abilities to detect and report significant risks to management and the board of directors on a timely basis. It should also reflect the internal and external auditor's capability to promote a safe, sound, and effective operation. The performance of an audit is rated based on an assessment of factors such as—

- the level of independence maintained by audit and the quality of the oversight and support provided by the board of directors and management;
- the adequacy of audit's risk-analysis methodology used to prioritize the allocation of audit resources and to formulate the audit schedule;
- the scope, frequency, accuracy, and timeliness of internal and external audit reports;
- the extent of audit participation in application development, acquisition, and testing, to ensure the effectiveness of internal controls and audit trails;
- the adequacy of the overall audit plan in providing appropriate coverage of IT risks;
- the auditor's adherence to codes of ethics and professional audit standards;
- the qualifications of the auditor, staff succession, and continued development through training;
- the existence of timely and formal follow-up and reporting on management's resolution of identified problems or weaknesses; and
- the quality and effectiveness of internal and external audit activity as it relates to IT controls.

A rating of 1 indicates strong audit performance. Audit independently identifies and reports weaknesses and risks to the board of directors or its audit committee in a thorough and timely manner. Outstanding audit issues are monitored until resolved. Risk analysis ensures that audit plans address all significant IT operations, procurement, and development activities with appropriate scope and frequency. Audit work is performed in accordance with professional auditing standards, and report content is timely, constructive, accurate, and complete. Because audit is strong, examiners may place substantial reliance on audit results.

A rating of 2 indicates satisfactory audit performance. Audit independently identifies and reports weaknesses and risks to the board of directors or audit committee, but reports may be less timely. Significant outstanding audit issues are monitored until resolved. Risk analysis ensures that audit plans address all significant IT operations, procurement, and development activities; however, minor concerns may be noted with the scope or frequency. Audit work is performed in accordance with professional auditing standards; however, minor or infrequent problems may arise with the timeliness, completeness, and accuracy of reports. Because

audit is satisfactory, examiners may rely on audit results but because minor concerns exist, examiners may need to expand verification procedures in certain situations.

A rating of 3 indicates less-than-satisfactory audit performance. Audit identifies and reports weaknesses and risks; however, independence may be compromised and reports presented to the board or audit committee may be less than satisfactory in content and timeliness. Outstanding audit issues may not be adequately monitored. Risk analysis is less than satisfactory. As a result, the audit plan may not provide sufficient audit scope or frequency for IT operations, procurement, and development activities. Audit work is generally performed in accordance with professional auditing standards; however, occasional problems may be noted with the timeliness, completeness, or accuracy of reports. Because audit is less than satisfactory, examiners must use caution if they rely on the audit results.

A rating of 4 indicates deficient audit performance. Audit may identify weaknesses and risks, but it may not independently report to the board or audit committee, and report content may be inadequate. Outstanding audit issues may not be adequately monitored and resolved. Risk analysis is deficient. As a result, the audit plan does not provide adequate audit scope or frequency for IT operations, procurement, and development activities. Audit work is often inconsistent with professional auditing standards, and the timeliness, accuracy, and completeness of reports is unacceptable. Because audit is deficient, examiners cannot rely on audit results.

A rating of 5 indicates critically deficient audit performance. If an audit function exists, it lacks sufficient independence and, as a result, does not identify and report weaknesses or risks to the board or audit committee. Outstanding audit issues are not tracked and no follow-up is performed to monitor their resolution. Risk analysis is critically deficient. As a result, the audit plan is ineffective and provides inappropriate audit scope and frequency for IT operations, procurement, and development activities. Audit work is not performed in accordance with professional auditing standards and major deficiencies are noted regarding the timeliness, accuracy, and completeness of audit reports. Because audit is critically deficient, examiners cannot rely on audit results.

## *Management*

The management rating reflects the abilities of the board and management as they apply to all aspects of IT acquisition, development, and operations. Management practices may need to address some or all of the following IT-related risks: strategic planning, quality assurance, project management, risk assessment, infrastructure and architecture, end-user computing, contract administration of third-party service providers, organization and human resources, and regulatory and legal compliance. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk-exposure levels and ensure that appropriate policies, procedures, and practices have been established. Sound management practices are demonstrated through active oversight by the board of directors and management, competent personnel, sound IT plans, adequate policies and standards, an effective control environment, and risk monitoring. The management rating should reflect the board's and management's ability as it applies to all aspects of IT operations. The performance of management and the quality of risk management are rated based on an assessment of factors such as—

- the level and quality of oversight and support of the IT activities by the board of directors and management;
- the ability of management to plan for and initiate new activities or products in response to information needs and to address risks that may arise from changing business conditions;
- the ability of management to provide information reports necessary for informed planning and decision making in an effective and efficient manner;
- the adequacy of, and conformance with, internal policies and controls addressing the IT operations and risks of significant business activities;
- the effectiveness of risk-monitoring systems;
- the timeliness of corrective action for reported and known problems;
- the level of awareness of and compliance with laws and regulations;
- the level of planning for management succession;
- the ability of management to monitor the services delivered and to measure the organi-

zation's progress toward identified goals effectively and efficiently;

- the adequacy of contracts and management's ability to monitor relationships with third-party servicers;
- the adequacy of strategic planning and risk-management practices to identify, measure, monitor, and control risks, including management's ability to perform self-assessments; and
- the ability of management to identify, measure, monitor, and control risks and to address emerging IT needs and solutions.

A rating of 1 indicates strong performance by management and the board. Effective risk-management practices are in place to guide IT activities, and risks are consistently and effectively identified, measured, controlled, and monitored. Management immediately resolves audit and regulatory concerns to ensure sound operations. Written technology plans, policies and procedures, and standards are thorough and properly reflect the complexity of the IT environment. They have been formally adopted, communicated, and enforced throughout the organization. IT systems provide accurate, timely reports to management. These reports serve as the basis for major decisions and as an effective performance-monitoring tool. Outsourcing arrangements are based on comprehensive planning; routine management supervision sustains an appropriate level of control over vendor contracts, performance, and services provided. Management and the board have demonstrated the ability to promptly and successfully address existing IT problems and potential risks.

A rating of 2 indicates satisfactory performance by management and the board. Adequate risk-management practices are in place and guide IT activities. Significant IT risks are identified, measured, monitored, and controlled; however, risk-management processes may be less structured or inconsistently applied and modest weaknesses exist. Management routinely resolves audit and regulatory concerns to ensure effective and sound operations; however, corrective actions may not always be implemented in a timely manner. Technology plans, policies and procedures, and standards are adequate and formally adopted. However, minor weaknesses may exist in management's ability to communicate and enforce them throughout the organization. IT systems provide quality reports to management which serve as a basis

for major decisions and a tool for performance planning and monitoring. Isolated or temporary problems with timeliness, accuracy, or consistency of reports may exist. Outsourcing arrangements are adequately planned and controlled by management, and they provide for a general understanding of vendor contracts, performance standards, and services provided. Management and the board have demonstrated the ability to address existing IT problems and risks successfully.

A rating of 3 indicates less-than-satisfactory performance by management and the board. Risk-management practices may be weak and offer limited guidance for IT activities. Most IT risks are generally identified; however, processes to measure and monitor risk may be flawed. As a result, management's ability to control risk is less than satisfactory. Regulatory and audit concerns may be addressed, but time frames are often excessive and the corrective action taken may be inappropriate. Management may be unwilling or incapable of addressing deficiencies. Technology plans, policies and procedures, and standards exist but may be incomplete. They may not be formally adopted, effectively communicated, or enforced throughout the organization. IT systems provide requested reports to management, but periodic problems with accuracy, consistency, and timeliness lessen the reliability and usefulness of reports and may adversely affect decision making and performance monitoring. Outsourcing arrangements may be entered into without thorough planning. Management may provide only cursory supervision that limits their understanding of vendor contracts, performance standards, and services provided. Management and the board may not be capable of addressing existing IT problems and risks, which is evidenced by untimely corrective actions for outstanding IT problems.

A rating of 4 indicates deficient performance by management and the board. Risk-management practices are inadequate and do not provide sufficient guidance for IT activities. Critical IT risks are not properly identified, and processes to measure and monitor risks are deficient. As a result, management may not be aware of and is unable to control risks. Management may be unwilling or incapable of addressing audit and regulatory deficiencies in an effective and timely manner. Technology plans, policies and procedures, and standards are inadequate and have not been formally adopted or effectively communicated throughout the organization, and manage-



ment does not effectively enforce them. IT systems do not routinely provide management with accurate, consistent, and reliable reports, thus contributing to ineffective performance monitoring or flawed decision making. Outsourcing arrangements may be entered into without planning or analysis, and management may provide little or no supervision of vendor contracts, performance standards, or services provided. Management and the board are unable to address existing IT problems and risks, as evidenced by ineffective actions and long-standing IT weaknesses. Strengthening of management and its processes is necessary.

A rating of 5 indicates critically deficient performance by management and the board. Risk-management practices are severely flawed and provide inadequate guidance for IT activities. Critical IT risks are not identified, and processes to measure and monitor risks do not exist or are not effective. Management's inability to control risk may threaten the continued viability of the institution. Management is unable or unwilling to correct audit- and regulatory-identified deficiencies, and immediate action by the board is required to preserve the viability of the institution. If they exist, technology plans, policies and procedures, and standards are critically deficient. Because of systemic problems, IT systems do not produce management reports that are accurate, timely, or relevant. Outsourcing arrangements may have been entered into without management planning or analysis, resulting in significant losses to the financial institution or ineffective vendor services.

### *Development and Acquisition*

The rating of development and acquisition reflects an organization's ability to identify, acquire, install, and maintain appropriate IT resources. Management practices may need to address all or parts of the business process for implementing any kind of change to the hardware or software used. These business processes include an institution's purchase of hardware or software, development and programming performed by the institution, purchase of services from independent vendors or affiliated data centers, or a combination of these activities. The business process is defined as all phases taken to implement a change, including researching alternatives available, choosing an appropriate option for the organization as a whole, and

converting to the new system or integrating the new system with existing systems. This rating reflects the adequacy of the institution's systems-development methodology and related risk-management practices for acquisition and deployment of IT. This rating also reflects the board and management's ability to enhance and replace IT prudently in a controlled environment. The performance of systems development and acquisition and related risk-management practice is rated based on an assessment of factors such as—

- the level and quality of oversight and support of systems-development and acquisition activities by senior management and the board of directors;
- the adequacy of the organizational and management structures to establish accountability and responsibility for IT systems and technology initiatives;
- the volume, nature, and extent of risk exposure to the financial institution in the area of systems development and acquisition;
- the adequacy of the institution's Systems Development Life Cycle (SDLC) and programming standards;
- the quality of project-management programs and practices that are followed by developers, operators, executive management or owners, independent vendors or affiliated servicers, and end-users;
- the independence of the quality-assurance function and the adequacy of controls over program changes;
- the quality and thoroughness of system documentation;
- the integrity and security of the network, system, and application software;
- the development of IT solutions that meet the needs of end-users; and
- the extent of end-user involvement in the system-development process.

A rating of 1 indicates strong systems-development, acquisition, implementation, and change-management performance. Management and the board routinely demonstrate successfully the ability to identify and implement appropriate IT solutions while effectively managing risk. Project-management techniques and the SDLC are fully effective and supported by written policies, procedures, and project controls that consistently result in timely and efficient project completion. An independent quality-

assurance function provides strong controls over testing and program-change management. Technology solutions consistently meet end-user needs. No significant weaknesses or problems exist.

A rating of 2 indicates satisfactory systems-development, acquisition, implementation, and change-management performance. Management and the board frequently demonstrate the ability to identify and implement appropriate IT solutions while managing risk. Project management and the SDLC are generally effective; however, weaknesses may exist that result in minor project delays or cost overruns. An independent quality-assurance function provides adequate supervision of testing and program-change management, but minor weaknesses may exist. Technology solutions meet end-user needs. However, minor enhancements may be necessary to meet original user expectations. Weaknesses may exist; however, they are not significant and are easily corrected in the normal course of business.

A rating of 3 indicates less-than-satisfactory systems-development, acquisition, implementation, and change-management performance. Management and the board may often be unsuccessful in identifying and implementing appropriate IT solutions; therefore, unwarranted risk exposure may exist. Project-management techniques and the SDLC are weak and may result in frequent project delays, backlogs, or significant cost overruns. The quality-assurance function may not be independent of the programming function, which may have an adverse impact on the integrity of testing and program-change management. Technology solutions generally meet end-user needs but often require an inordinate level of change after implementation. Because of weaknesses, significant problems may arise that could result in disruption to operations or significant losses.

A rating of 4 indicates deficient systems-development, acquisition, implementation, and change-management performance. Management and the board may be unable to identify and implement appropriate IT solutions and do not effectively manage risk. Project-management techniques and the SDLC are ineffective and may result in severe project delays and cost overruns. The quality-assurance function is not fully effective and may not provide independent or comprehensive review of testing controls or program-change management. Technology solutions may not meet the critical needs of the

organization. Problems and significant risks exist that require immediate action by the board and management to preserve the soundness of the institution.

A rating of 5 indicates critically deficient systems-development, acquisition, implementation, and change-management performance. Management and the board appear to be incapable of identifying and implementing appropriate IT solutions. If they exist, project-management techniques and the SDLC are critically deficient and provide little or no direction for development of systems or technology projects. The quality-assurance function is severely deficient or not present, and unidentified problems in testing and program-change management have caused significant IT risks. Technology solutions do not meet the needs of the organization. Serious problems and significant risks exist, which raise concern for the financial institution's ongoing viability.

### *Support and Delivery*

The rating of support and delivery reflects an organization's ability to provide technology services in a secure environment. It reflects not only the condition of IT operations but also factors such as reliability, security, and integrity, which may affect the quality of the information-delivery system. The factors include user support and training, as well as the ability to manage problems and incidents, operations, system performance, capacity planning, and facility and data management. Risk-management practices should promote effective, safe, and sound IT operations that ensure the continuity of operations and the reliability and availability of data. The scope of this component rating includes operational risks throughout the organization. The rating of IT support and delivery is based on a review and assessment of requirements such as—

- the ability to provide a level of service that meets the requirements of the business;
- the adequacy of security policies, procedures, and practices in all units and at all levels of the financial institution;
- the adequacy of data controls over preparation, input, processing, and output;
- the adequacy of corporate contingency planning and business resumption for data centers, networks, and business units;

- the quality of processes or programs that monitor capacity and performance;
- the adequacy of controls and the ability to monitor controls at service providers;
- the quality of assistance provided to users, including the ability to handle problems;
- the adequacy of operating policies, procedures, and manuals;
- the quality of physical and electronic security, including the privacy of data; and
- the adequacy of firewall architectures and the security of connections with public networks.

A rating of 1 indicates strong IT support and delivery performance. The organization provides technology services that are reliable and consistent. Service levels adhere to well-defined service-level agreements and routinely meet or exceed business requirements. A comprehensive corporate contingency and business-resumption plan is in place. Annual contingency-plan testing and updating is performed, and critical systems and applications are recovered within acceptable time frames. A formal written data-security policy and awareness program is communicated and enforced throughout the organization. The logical and physical security for all IT platforms is closely monitored, and security incidents and weaknesses are identified and quickly corrected. Relationships with third-party service providers are closely monitored. IT operations are highly reliable, and risk exposure is successfully identified and controlled.

A rating of 2 indicates satisfactory IT support and delivery performance. The organization provides technology services that are generally reliable and consistent; however, minor discrepancies in service levels may occur. Service performance adheres to service agreements and meets business requirements. A corporate contingency and business-resumption plan is in place, but minor enhancements may be necessary. Annual plan testing and updating is performed, and minor problems may occur when recovering systems or applications. A written data-security policy is in place but may require improvement to ensure its adequacy. The policy is generally enforced and communicated throughout the organization, for example, through a security-awareness program. The logical and physical security for critical IT platforms is satisfactory. Systems are monitored, and security incidents and weaknesses are identified and resolved within reasonable time frames. Relationships with third-party service providers are

monitored. Critical IT operations are reliable and risk exposure is reasonably identified and controlled.

A rating of 3 indicates that the performance of IT support and delivery is less than satisfactory and needs improvement. The organization provides technology services that may not be reliable or consistent. As a result, service levels periodically do not adhere to service-level agreements or meet business requirements. A corporate contingency and business-resumption plan is in place but may not be considered comprehensive. The plan is periodically tested; however, the recovery of critical systems and applications is frequently unsuccessful. A data-security policy exists; however, it may not be strictly enforced or communicated throughout the organization. The logical and physical security for critical IT platforms is less than satisfactory. Systems are monitored; however, security incidents and weaknesses may not be resolved in a timely manner. Relationships with third-party service providers may not be adequately monitored. IT operations are not acceptable, and unwarranted risk exposures exist. If not corrected, weaknesses could cause performance degradation or disruption to operations.

A rating of 4 indicates deficient IT support and delivery performance. The organization provides technology services that are unreliable and inconsistent. Service-level agreements are poorly defined and service performance usually fails to meet business requirements. A corporate contingency and business-resumption plan may exist, but its content is critically deficient. If contingency testing is performed, management is typically unable to recover critical systems and applications. A data-security policy may not exist. As a result, serious supervisory concerns over security and the integrity of data exist. The logical and physical security for critical IT platforms is deficient. Systems may be monitored, but security incidents and weaknesses are not successfully identified or resolved. Relationships with third-party service providers are not monitored. IT operations are not reliable and significant risk exposure exists. Degradation in performance is evident and frequent disruption in operations has occurred.

A rating of 5 indicates critically deficient IT support and delivery performance. The organization provides technology services that are not reliable or consistent. Service-level agreements do not exist, and service performance does not

meet business requirements. A corporate contingency and business-resumption plan does not exist. Contingency testing is not performed, and management has not demonstrated the ability to recover critical systems and applications. A data-security policy does not exist, and a serious threat to the organization's security and data integrity exists. The logical and physical security for critical IT platforms is inadequate, and management does not monitor systems for security incidents and weaknesses. Relationships with third-party service providers are not monitored, and the viability of a service provider may be in jeopardy. IT operations are severely deficient, and the seriousness of weaknesses could cause failure of the financial institution if not addressed.

## OUTSOURCING INFORMATION TECHNOLOGY

Banking organizations are increasingly relying on services provided by other entities to support a range of banking operations. Outsourcing of information- and transaction-processing activities, either to affiliated institutions or third-party service providers, may help banking organizations manage data processing and related personnel costs, improve services, and obtain expertise not available internally. At the same time, the reduced operational control over outsourced activities may expose an institution to additional risks. The federal banking agencies have established procedures to examine and evaluate the adequacy of institutions' controls over service providers, which can be found in the FFIEC's *IT Handbook* and related guidance. Additional information on specific areas is provided later in this section.

The FFIEC has issued the statement Risk Management of Outsourced Technology Services. (See SR-00-17.) This supplemental bank interagency guidance contains many of the same sound practices and recommendations that are in SR-00-4 (Outsourcing of Information and Transaction Processing) and this section. However, the FFIEC policy provides banking organizations with additional specific information that may be useful when considering their outsourcing risk-management practices. The guidance focuses on the risk-management process of identifying, measuring, monitoring, and controlling the risks associated with outsourcing technology

services. While outsourcing can improve banking services, help to control costs, and provide the technical assistance needed to maintain and expand product offerings, it also introduces additional risks that need to be addressed. The guidance includes four key elements to address those risks: risk assessment, service-provider selection, contract provisions and review, and ongoing service-provider monitoring. An appendix to the policy statement provides examples of considerations that may be relevant when performing due diligence in selecting a service provider, contracting with service providers, and conducting ongoing service-provider monitoring. The FFIEC policy statement and its appendix are included as appendix A at the end of this section.

In the development of the examination scope and risk profile, examiners should determine which information- and transaction-processing activities critical to the institution's core operations are outsourced. During the on-site examination, the adequacy of the institution's risk management for these critical service providers should be assessed and evaluated. The overall assessment should be reflected in the relevant components of the URSIT examination rating or the Uniform Financial Institution Rating System, if an information-systems rating is not assigned.

## Outsourcing Risks

The outsourcing of information and transaction processing involves operational risks that are similar to those that arise when the functions are performed internally, such as threats to the availability of systems used to support customer transactions, the integrity or security of customer account information, or the integrity of risk-management information systems. Under outsourcing arrangements, however, the risk-management measures commonly used to address these risks, such as internal controls and procedures, are generally under the direct operational control of the service provider. Nevertheless, the serviced institution would bear the associated risk of financial loss, reputational damage, or other adverse consequences.

Some outsourcing arrangements also involve direct financial risks to the serviced institution. For example, in some transaction-processing activities, a service provider has the ability to process transactions that result in extensions of

credit on behalf of the serviced institution.<sup>19</sup> A service provider may also collect or disburse funds, exposing the institution to liquidity and credit risks if the service provider fails to perform as expected.

## Risk Management

The Federal Reserve expects institutions to ensure that controls over outsourced information- and transaction-processing activities are equivalent to those that would be implemented if the activity were conducted internally. (See SR-00-4.) The institution's board of directors and senior management should understand the key risks associated with the use of service providers for its critical operations, commensurate with the scope and risks of the outsourced activity and its importance to the institution's business. They should ensure that an appropriate oversight program is in place to monitor each service provider's controls, condition, and performance. The following eight areas should be included in this process:

1. *Risk assessment.* Before entering into an outsourcing arrangement, the institution should assess the key risks that may arise and options for controlling these risks. Factors influencing the risk assessment could include how critical the outsourced function is to the institution; the nature of activities to be performed by the service provider, including handling funds or implementing credit decisions; the availability of alternative service providers for the particular function; insurance coverage available for particular risks; and the cost and time required to switch service providers if problems arise.
2. *Selection of service provider.* In selecting a service provider for critical information- or transaction-processing functions, an institution should perform sufficient due diligence to satisfy itself of the service provider's competence and stability, both financially and operationally, to provide the expected services and meet any related commitments.<sup>20</sup>
3. *Contracts.* The written contract between the institution and the service provider should clearly specify, at a level of detail commensurate with the scope and risks of the outsourced activity, all relevant terms, conditions, responsibilities, and liabilities of both parties. These would normally include terms such as—
  - required service levels, performance standards, and penalties;
  - internal controls, insurance, disaster-recovery capabilities, and other risk-management measures maintained by the service provider;
  - data and system ownership and access;
  - liability for delayed or erroneous transactions and other potential risks;
  - provisions for the institution to require and have access to internal or external audits or other reviews of the service provider's operations and financial condition;
  - compliance with any applicable regulatory requirements and access to information and operations by the institution's supervisory authorities; and
  - provisions for handling disputes, contract changes, and contract termination.
 Terms and conditions should be assessed by the institution to ensure that they are appropriate for the particular service being provided and result in an acceptable level of risk to the institution.<sup>21</sup> Contracts for outsourcing of critical functions should be reviewed by the institution's legal counsel.
4. *Policies, procedures, and control.* The service provider should implement internal control policies and procedures, data-security and contingency capabilities, and other operational controls analogous to those that the institution would use if it performed the activity internally. Appropriate controls should be placed on transactions processed or funds handled by the service provider on behalf of the institution. The service provider's policies and procedures should be reviewed by client institutions.

may apply. In particular, section 23B provides that the terms of transactions between a bank and its nonbank affiliate must be comparable to the terms of similar transactions between nonaffiliated parties.

21. Additional information regarding common contract provisions can be found later in this section and in the FFIEC's *IT Handbook*. In addition, FFIEC Supervisory Policy SP-5 requires each serviced institution to evaluate the adequacy of its service provider's contingency plans.

19. For example, an institution may authorize a service provider to originate payments, such as ACH credit transfers, on behalf of customers. The institution is required by law or contract to honor these types of transactions.

20. When the service provider is affiliated with the serviced institution, sections 23A and 23B of the Federal Reserve Act



5. *Ongoing monitoring.* The institution should review the operational and financial performance of critical service providers on an ongoing basis to ensure that the service provider is meeting and can continue to meet the terms of the arrangement. The institution's staff should have sufficient training and expertise to review the service provider's performance and risk controls.

6. *Information access.* The institution must ensure that it has complete and immediate access to information that is critical to its operations and that is maintained or processed by a service provider. Records maintained at the institution must be adequate to enable examiners to review its operations fully and effectively, even if a function is outsourced.

7. *Audit.* The institution's audit function should review the oversight of critical service providers. Audits of the outsourced function should be conducted according to a scope and frequency appropriate for the particular function. Serviced institutions should conduct audits of the service provider or regularly review the service provider's internal or external audit scope and findings. Service providers should have an effective internal audit function or should commission comprehensive, regular audits from a third-party organization. The reports of external auditors are commonly based on the AICPA's Statement of Auditing Standards [SAS] No. 70 "Reports on the Processing of Transactions by Service Organizations," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55." These statements contain the external-auditor reporting tools commonly used for service providers. SAS 70 reports, however, should not be relied on to the same extent as an audit. There are two types of SAS 70 reports:

- *Reports on controls placed in operation* is an auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements. It also reports on whether such controls were suitably designed to achieve specified control objectives. Lastly, it reports on whether the controls had been placed in operation as of a specific date.
- *Reports on controls placed in operation*

*and tests of operating performance* is an auditor's report on a service organization's controls as described above, but the report also includes information on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

Audit results, audit reports, and management responses must be available to examiners upon request.

8. *Contingency plans.* The serviced institution should ensure adequate business-resumption planning and testing by the service provider. When appropriate based on the scope and risks of the outsourced function and the condition and performance of the service provider, the serviced institution's contingency plan may also include plans for the continuance of processing activities, either in-house or with another provider, in the event that the service provider is no longer able to provide the contracted services or the arrangement is otherwise terminated unexpectedly.

## International Considerations

In general, the arrangements for outsourcing critical information- or transaction-processing functions to service providers outside the United States should be conducted according to the risk-management guidelines described above. In addition, the Federal Reserve expects that these arrangements will not diminish the ability of U.S. supervisors to effectively review the domestic or foreign operations of U.S. banking organizations and the U.S. operations of foreign banking organizations. (See SR-00-4.) In particular, examiners should evaluate the adequacy of outsourcing arrangements in the following six areas:

1. *Oversight and compliance.* The institution is expected to demonstrate adequate oversight of a foreign service provider, such as through comprehensive audits conducted by the service provider's internal or external auditors, the institution's own auditors, or foreign bank supervisory authorities. The arrangement must not hinder the ability of the institution to comply with all applicable U.S.

- laws and regulations, including, for example, requirements for accessibility and retention of records under the Bank Secrecy Act. (See the U.S. Department of the Treasury's rule at 31 CFR 103.18. See also section 208.62 of the Board's Regulation H (12 CFR 208.62) for suspicious-activity reporting and section 208.63 (12 CFR 208.63) for the Bank Secrecy Act compliance program.)
2. *Information access.* The outsourcing arrangement should not hinder the ability of U.S. supervisors to reconstruct the U.S. activities of the organization in a timely manner, if necessary. Outsourcing to jurisdictions where full and complete access to information may be impeded by legal or administrative restrictions on information flows will not be acceptable unless copies of records pertaining to U.S. operations are also maintained at the institution's U.S. office.
  3. *Audit.* Copies of the most recent audits of the outsourcing arrangement must be maintained in English at the institution's U.S. office and must be made available to examiners upon request.
  4. *Contingency plan.* The institution's contingency plan must include provisions to ensure timely access to critical information and service resumption in the event of unexpected national or geographic restrictions or disruptions affecting a foreign service provider's ability to provide services. Depending on the scope and risks of the outsourced function, this may necessitate backup arrangements with other U.S. or foreign service providers in other geographic areas.
  5. *Foreign banking organizations.* With the exception of a U.S. branch or agency of a foreign bank that relies on the parent organization for information- or transaction-processing services, foreign banking organizations should maintain at the U.S. office documentation of the home office's approval of outsourcing arrangements supporting its U.S. operations, whether to a U.S. or foreign service provider. The organization's U.S. office should also maintain documentation demonstrating appropriate oversight of the service provider's activities, such as written contracts, audit reports, and other monitoring tools. When appropriate, the Federal Reserve will coordinate with a foreign banking organization's home-country supervisor to ensure that it does not object to the outsourcing arrangement.
  6. *Foreign branches or subsidiaries of U.S. banks and Edge corporations.* Documentation relating to outsourcing arrangements of the foreign operations of U.S. banking organizations with foreign service providers should be made available to examiners upon request.

## INFORMATION-PROCESSING ENVIRONMENT

Many factors influence an institution's decision about whether to use internal or external data processing services, including the initial investment, operating costs, and operational flexibility. Historically, small financial institutions, which usually lack the funds or transaction volume to justify an in-house information system, were the chief users of external data processing companies. However, as advances in technology have decreased the cost of data processing, small institutions have become much more willing to invest in an in-house information system. At the same time, some financial institutions with internal information systems have discovered that they can save money by using external data processing companies for certain banking applications. Other financial institutions have engaged national companies or facilities-management organizations to assume their processing operations, while certain holding companies have organized their data processing departments as subsidiaries to centralize operations for their affiliate institutions.

The decision to establish an internal data processing center is a major one. Any bank's board of directors and management considering such a decision should thoroughly review and consider alternatives before proceeding. While a bank may gain a number of competitive advantages from an in-house facility, there are also many risks associated with this decision. Technological advances have reduced the price of small computer networks and made them more affordable, but banks should not use this as the sole justification for an internal data processing center.

A comprehensive feasibility study should precede any decision to develop an in-house system. This study should describe the costs, benefits, and risks and also give management the opportunity to compare current and future needs with existing abilities. The FFIEC's *IT Hand-*

*book* contains a complete discussion of feasibility studies.

The management of a financial institution must carefully identify the organization's needs for data processing. After these needs are properly identified (including the customers' needs for these services), management must carefully evaluate how the institution can best meet them. The costs and complexity of changing data processing arrangements can be substantial, so management must ensure that all related costs and benefits are identified and considered before deciding on a service. The following are the major external providers of data processing and IT services for financial institutions.

## Correspondent Banks

Small financial institutions sometimes receive their IT services from a major correspondent bank. These services may be just one of a host of services available from the correspondent. Historically, the correspondent bank has been the least expensive servicer for many institutions. Correspondent banks may offset some of their own IT costs by using their excess processing capacity to provide services to correspondents.

## Affiliated Financial Institutions and Banking Organizations

IT departments in holding companies or subsidiaries are one common form of an affiliated servicer. An affiliated data center may offer cost savings to other affiliates, since all parties are generally using the same software system. The serviced institutions can eliminate the duplication of tasks, and the affiliated data center and the overall organization can realize cost savings through economies of scale. Thus, charges for IT services to affiliates are generally very competitive.

Regulatory guidelines strictly govern IT-servicing arrangements between affiliated institutions. Sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 371c-1) address the question of allowable transactions between affiliates. This statute also states that the terms of transactions between affiliated parties must be comparable to the terms of similar transactions between nonaffiliated parties. An affiliated data center is allowed to set fees to recover its costs

or to recover its costs plus a reasonable profit, or to set charges for data processing services that are comparable to those of a nonaffiliated servicer. Other restrictions may also apply.

## Independent Service Bureaus

Independent service bureaus are present in most areas, but mergers and acquisitions have caused the number of bureaus to decline. When management investigates a service bureau's operations, it should determine if the servicer is familiar with the IT needs of financial institutions. Determining the percentage of the service bureau's business that comes from financial institutions will help the institution select a vendor that specializes in this type of processing. Independent service bureaus are normally responsive to user requests for specialized programs, since developing these programs for clients is generally a significant source of revenue. Tailoring a software program to a particular institution's needs becomes less attractive to the independent service bureau if the institution accounts for only a small portion of the bureau's workload or if the bureau offers a standardized software package as its primary product. However, some standardized software systems allow a modest amount of processing and report adjustments without requiring servicer modifications. Also, report-generator software, which provides clients with customized reports they can prepare without any help from the service bureau, is sometimes available from service bureaus.

## Cooperative Service Corporations

A cooperative service corporation is a data processing facility formed by a group of financial institutions that agrees to share the operating costs. Under the right circumstances, this arrangement works well. For this strategy to succeed, however, all members of the group must be the same approximate size and have similar IT requirements. Typically, each institution owns a share of the facility or bears a share of the costs on a pro rata basis through investment in a bank service corporation. There must be a strong working relationship among the institutions. Although the institutions are not directly involved in the data processing center's



daily operations, they are ultimately responsible for the center's success or failure.

One advantage of a cooperative service corporation is that individual institutions have increased control over the design of the data processing operation. Therefore, institutions can tailor computerized applications to meet their own needs. Resource pooling often provides for economies of scale as well, and cooperative ventures normally attract more highly skilled and more experienced employees.

## Facilities-Management Providers

Medium- and large-sized financial institutions that already have an in-house data processing facility are the most likely users of facilities-management (FM) contracts. Small institutions typically do not have the work volume that is a prerequisite to hiring an FM company. Service contracts with FM companies are usually for a minimum term of five years, during which time the FM company assumes full responsibility for the institution's data processing operations. The institution pays the FM company a monthly fee to reimburse it for the costs of providing IT services plus a profit. The FM company usually carries out its tasks in the institution's former data processing center.

Financial institutions have various reasons for using FM companies, such as controlling or reducing the growth of data processing costs, ensuring better management of data center personnel, or using more modern software systems. Management of financially strained institutions may enter into FM arrangements to augment their capital position by selling their equipment or facilities to the FM company.

Although an institution's contract with an FM company may provide a quick and easy solution to data processing problems with minimal involvement of senior officials, management should be aware of potential problems. FM contracts can have clauses that require the institution to pay more for services as work volume grows and can also contain provisions for periodic increases. The contract may include a substantial penalty for cancellation. Another risk is that the FM company may make personnel changes that are not advantageous to the institution, such as reassigning its best workers elsewhere or reducing the size of the data processing staff. Bank management should make

sure that FM service contracts contain specific quality-measurement clauses and should monitor the quality of data processing services provided.

## Other Purchased Services

### *Computer Time*

A financial institution that designed its own data processing system and that maintains its own files only needs to rent computer time from an external servicer. This arrangement usually occurs when the financial institution's equipment or schedule makes it unable to handle some unusual processing task.

### *Time-Shared Computer Services*

Most external providers of time-sharing services have a library of standardized programs available to any user. A user also may generate programs and store them in a reserved library. Financial institutions frequently use time-sharing services for financial analysis rather than recordkeeping. Applications with low input and output requirements and repetitive calculations, such as those required for a securities portfolio, lend themselves to a time-sharing arrangement. The external servicer in this arrangement normally does not maintain the client institution's data files. Financial institutions that store master files on the external servicer's equipment should maintain adequate documentation to facilitate the examination process. Under this arrangement, management should be concerned about ensuring logical and physical access to the terminal and about the availability of audit trails that indicate who has made changes to master files. Management should establish and monitor controls over passwords, terminals, and access to master files. For a complete discussion of controls over passwords and terminals, see the FFIEC's *IT Handbook*.

### *Satellite Processing*

Satellite (remote) processing has become popular with some financial institutions that are located far away from an external servicer and that must process a large volume of transactions. A distinguishing characteristic of satellite pro-

cessing is that the institution and the data center each perform a portion of the processing. Although the institution collects the data and sometimes prepares reports, the servicer makes the necessary master-file updates. To capture data and print reports, the serviced institution must acquire a terminal-entry device, a printer, an MICR reader/sorter, and a tape or disk unit. Since the system is usually online, the serviced institution must install modems and communications lines linking it to the servicer. The level of skill necessary to perform remote job entry in a satellite system is less sophisticated than the level needed to operate an in-house system. Most of the traditional control functions remain at the institution. The FFIEC's *IT Handbook* contains further information on satellite processing, remote job entry, and distributive processing systems.

### *Standard Program Packages*

Most bank data centers and service bureaus specialize in processing one or more standard software packages. By using the same software for several users, external servicers achieve certain operating economies, which allow them to recover initial development costs more quickly. Most standard software packages are parameter driven, providing the user with some degree of flexibility. For example, in demand deposit and savings applications, standard program modules or common subroutines often allow the user to designate the format and frequency of reports. In addition, the user may select the parameters necessary to generate certain reports, such as the number of inactive days before an account becomes dormant or the minimum dollar amount for checks listed on the large-item report. The user can also be involved in selecting the criteria for interest rates, balance requirements, and other operating values, allowing for a tailored application within a standardized software system.

### *Tailored Applications*

If standard program packages do not meet a financial institution's needs, an external servicer can be hired to design tailored applications to process the institution's data. The institution must clearly describe the proposed system and its operations to the servicer. Internal or external

auditor participation in reviewing controls is also advisable. The initial cost of this approach is high, as are the costs of maintaining and updating the tailored applications.

## OPERATIONAL AND TECHNOLOGICAL USER CONTROLS

Using computerized programs and networks, banks maintain a large number of accounts and record a high volume of transactions every day. Text-processing systems store vast amounts of correspondence. Transmission of data and funds regularly occurs over public communications links, such as telephone lines and satellite networks. The use of new technologies to transfer funds and records, while improving customer service and the institution's internal operations, has increased the potential for errors and abuse, which can result in loss of funds, lawsuits arising from damaged reputations, improper disclosure of information, and regulatory sanctions.

Controls must be implemented to minimize the vulnerability of all information and to keep funds secure. Bank management must assess the level of control necessary in view of the degree of exposure and the impact of unexpected losses on the institution. Certain practices can strengthen information and financial security. The most basic practices are the implementation of sound policies, practices, and procedures for physical security, separation of duties, internal quality control, hardware and software access controls, and audits. Bank management should institute information security controls that are designed to—

- ensure the integrity and accuracy of management information systems;
- prevent unauthorized alteration during data creation, transfer, and storage;
- maintain confidentiality;
- restrict physical access;
- authenticate user access;
- verify the accuracy of processing during input and output;
- maintain backup and recovery capability; and
- provide environmental protection against damage or destruction of information.

Although security features vary, they are usually available for all computer systems. The controls

adopted should apply to information produced and stored by both automated and manual methods.

Written policies are generally recommended and, in most cases, institutions have chosen to establish and communicate security principles in writing. However, if an institution follows sound fundamental principles to control the risks discussed here, a written policy is not necessarily required. If sound principles are not effectively practiced, management may be required to establish written policies to formally communicate risk parameters and controls. Federal Reserve System policy does, however, require written contingency and disaster-recovery plans.

Examiners should regularly conduct reviews of information security. These reviews may include an assessment of—

- the adequacy of security practices,
- compliance with security standards, and
- management supervision of information security activities.

When conducting reviews of controls over information security, examiners must understand the difference between master files and transaction files. A master file is a main reference file of information used in a computer system, such as all mortgage loans. It provides information to be used by the program and can be updated and maintained to reflect the results of the processed operation. A transaction file or detail file contains specific transaction information, such as mortgage loan payments.

## Manual Controls

The following discussion covers basic operational controls in a financial institution receiving external IT services. Similar controls should also be applied to information processed by an IT department within a user's own institution.

### *Separation of Duties*

A basic form of operational control is separation of duties. With this control in place, no one person should be able to both authorize and execute a transaction, thereby minimizing the risk of undetected improper activities. Data center personnel should not initiate transactions or correct data except when it is necessary to

complete processing in a reasonable time period. If this unusual situation arises, proper authorization should be obtained from data center and bank management. Both the servicer and the serviced institution should maintain documentation of these approvals, including details of the circumstances requiring the action. The same person normally should not perform input and output duties. However, in some instances, staff limitations may make one person responsible for several activities, such as—

- preparing batches and blocks or other input for entry to the system or shipment to the servicer;
- operating data entry equipment, including check reader/sorter machines, proof machines, or data-conversion devices;
- preparing rejects and nonreaders for reentry into the system;
- reconciling output to input or balancing the system;
- distributing output to ultimate users; and
- posting the general ledger and balancing computer output to the general ledger.

Rotation of assignments and periodic scheduled absences may improve internal controls by preventing one person from controlling any one job for an extended time period (and by providing cross-training and backup for all personnel). When vacations are scheduled, management may require staff to take uninterrupted vacations that are long enough to allow pending transactions to clear. These practices are most effective if vacations or other types of absences extend over the end of an accounting period or are for two consecutive weeks. Written policies and procedures may require job rotation.

Application manuals usually consist of a user's guide provided by the servicer that is supplemented by procedures written by the user. Manuals normally cover the preparation and control of source documents, certain control practices for moving documents or electronic images to and from the user and servicer, the daily reconciliation of totals to the general ledger, and master-file changes.

Management should implement dual control over automated systems. Personnel should place supervisory holds on customer accounts requiring special attention. For example, dormant accounts, collateral accounts, and accounts with large uncollected funds balances generally have holds that can be removed only by authoriza-

tions from two bank officials. In addition, certain types of transactions (for example, master-file changes) should require authorization from two bank officials by means of special codes or terminal keys. When employees add or remove a hold on an account or when the system completes a transaction requiring supervisory approval, the computer should generate an exception report. Assigned personnel not involved in the transaction should promptly review these reports for unusual or unauthorized activity.

### *Internal Quality Controls*

Generally, there are three basic types of information systems, with many combinations and variations:

- *Inquiry-only system.* This system allows the user to search and review machine-readable records but not to alter them. Controls and security concerns related to this system are few; the major concern is unauthorized access to confidential information.
- *Memo-post system.* More sophisticated than the inquiry-only system, the memo-post system allows the user to create interim records. The servicer performs permanent posting routines using batch-processing systems. Controls for a memo-post system include limiting physical and logical access to the system and restricting certain transactions to supervisory personnel only. Appropriate levels of management should review memo-post reports daily.
- *Online-post system.* This system, sometimes called a real-time system, requires the strictest controls. Online-post systems are vulnerable because all accepted transactions are transferred to machine-readable records. In addition to access controls, system reports should record all activity and exceptions. Appropriate levels of management should review these reports daily.

Internal controls fall into three general categories:

- *Administrative controls.* Administrative controls usually consist of management review of daily operations and output reports. Each application includes basic controls and exception reports that are common to all operations. To be effective, operations personnel must properly use exception reports and controls. This is especially true for controlling dormant

accounts, check kiting, draws against uncollected funds, overdrafts, and the posting of computer-generated income and expense entries.

- *Dollar controls.* Dollar controls ensure processing for all authorized transactions. Operations personnel should establish work and control totals before forwarding data records to the data processor. Those same employees should not complete balancing procedures by reconciling trial balances to input, control sheets, and the general ledger. Report distribution should follow a formal procedure. Personnel should account for all rejects corrected and resubmitted.
- *Condoler controls.* Condoler controls are used when dollar values are not present in the data, as in name and address changes. Controls should be established before forwarding work for processing. Management should also implement procedures designed to ensure that its servicer processes all condoler transactions. For example, personnel should check new-account reports against new-account input forms or written customer-account applications to make sure that data are properly entered. To protect data integrity, management should develop procedures to control master-file and program changes. These procedures should also verify that the servicer is making only authorized changes and ensure that data processing employees do not initiate master-file changes.

## Technological Controls

### *Encryption*

Encryption is a process by which mathematical algorithms are used to convert plain text into encrypted strings of meaningless symbols and characters. This helps prevent unauthorized viewing and altering of electronic data during transmission or storage. The industry commonly uses the Data Encryption Standard (DES) for encoding personal identification numbers (PINs) on access cards, storing user passwords, and transferring funds on large-dollar payment networks.

### *Message-Authentication Code*

A message-authentication code (MAC) is a code

designed to protect against unauthorized alteration of electronic data during transmission or storage. This code is used with data encryption to further secure the transmission of large-dollar payments.

### *User Passwords*

User passwords consist of a unique string of characters that a programmer, computer operator, or user must supply before gaining access to the system or data. These are individual access codes that should be specific to the user and known only to the user. Other security features of passwords should, at a minimum, require the users to change them periodically and store them in encrypted files. In addition, the passwords should be composed of a sufficient number of alphanumeric characters to make them difficult to guess. User passwords should not be displayed during the access process and should not be printed on reports.

### *Security Software*

Security software is software designed to restrict access to computer-based data, files, programs, utilities, and system commands. Some systems can control access by user, transaction, and terminal. The software can generate reports that log actual and attempted security violations as well as access to the system.

### *Restricted Terminals*

Limiting certain types of transactions to certain terminals or groups of terminals can help reduce exposure to loss. The offsetting problem is that loss of the ability to use these terminals can stop processing for an entire application. Bank management should therefore evaluate both the exposure and processing risks.

An automatic time-out feature can minimize the exposure risk. Since unauthorized users may target an unattended terminal, this feature automatically signs off the user when there has been no activity for a certain period of time. Using time-of-day restrictions can also limit unauthorized use of terminals during periods when an entire department or section would be unattended.

### *Restricted Transactions*

Restricted transactions are specialized transactions that can be performed only by supervisory or management personnel. Examples include reversing transactions, dollar adjustments to customer accounts, and daily balancing transactions. Management should periodically review user needs and the appropriateness of restricting the performance of these transactions. System-generated reports can be used to review this activity more frequently.

### *Activity and Exception Reports*

Report output will vary, depending on the sophistication of the data communications and applications software. Management should receive activity reports that detail transactions by terminal, operator, and type. More sophisticated software will produce activity and exception reports on other criteria, such as the number of inquiries by terminal, unsuccessful attempts to access the system, unauthorized use of restricted information, and any unusual activities (that is, infrequently used transactions).

Activity reports are used to monitor system use and may not be printed daily. However, management should periodically review and summarize these reports in an effort to ensure that machines are used efficiently. Exception reports should be produced and reviewed daily by designated personnel who have no conflicting responsibilities. A problem with many reporting systems is that the log contains a record of every event, making it cumbersome and more difficult to identify problems.

### **Controls over Software-Program-Change Requests**

Requests for system changes, such as software-program changes, should be documented on a standard change-request form. The form is used to describe the request and document the review and approval process. It should contain the following information:

- date of the change request
- sequential control number
- program or system identification
- reason for the change
- description of the requested change

- person requesting the change
- benefits contemplated from the change
- projected cost
- signed approval authorizing the change including, at a minimum, the user, IT personnel with the proper authority, and an auditor (at least for significant changes)
- name of programmer assigned to make the change
- anticipated completion date
- user and information systems approval of the completed program change
- implementation procedures (steps for getting the program into the production library)
- audit review of change (if deemed necessary)
- documented sign-off

## End-User Computing

End-user computing results from the transfer of information-processing capabilities from centralized data centers onto the user's desktop. End-user computing systems may range in size and computing power from laptop notebook computers to standalone personal computers, client server networks, or small systems with sufficient computing power to process all significant applications for a financial institution. Small systems that are entirely supported by a hardware or software vendor are referred to as turnkey systems. Control considerations discussed throughout this subsection generally apply to all end-user computing systems.

In many cases, end-user systems are linked by distributed processing networks. Linking several microcomputers together and passing information between them is called networking. A system configured in this manner is commonly called a local area network (LAN). The ability to decentralize the data processing function is largely a result of the development of powerful microcomputers or PCs. Microcomputers are now powerful enough to process significant applications when used as standalone systems. These microcomputers can also be connected to a host computer and configured to serve as a data entry or display terminal. In this terminal-emulation mode, information can be passed between the host and the PC with the processing occurring at either machine.

When linked by a network, end-user computing offers several advantages to financial institutions, including—

- low cost compared with other platforms,
- efficiency through the sharing of resources,
- ease of expansion for future growth,
- enhanced communication capabilities,
- portability,
- data availability, and
- ease of use.

While end-user computing systems provide several advantages, they also have greater risks to data integrity and data security, including—

- difficulty in controlling access to the system and in controlling access to confidential information that may be stored on individual personal computers and not on the system (such as payroll records, spreadsheets, budgets, and information intended for the board of directors of the financial institution),
- the lack of sophisticated software to ensure security and data integrity,
- insufficient capabilities to establish audit trails,
- inadequate program testing and documentation,
- lack of segregated duties of data entry personnel.

As the trend toward distributed processing continues, financial institutions should have



proper policies, procedures, and reporting to ensure the accurate and timely processing of information. The controls governing access in an end-user computing environment should be no less stringent than those used in a traditional mainframe environment. Strict rules should govern the ability of users to access information. As a general rule, no user should be able to access information that is beyond what is needed to perform the tasks required by his or her job description. In this new environment, management and staff should assume responsibility for the information assets of the organization.

## CONTINGENCY PLANNING, RECORD PROTECTION, AND RETENTION

Data communications systems are susceptible to software, hardware, and transmission problems that may make them unusable for extended periods of time. If a financial institution depends on data communication for its daily operations, appropriate back-up provisions are necessary. Back-up is the ability to continue processing applications in the event the communications system fails. Management can provide back-up by various methods, including batch-processing systems, intelligent terminals or PCs operating in an off-line mode, data capture at the controller if transmission lines are lost, redundant data communication lines, and back-up modems.

Regardless of the method used, FFIEC interagency issuances and specific supporting Federal Reserve System policy issuances that address corporate contingency planning require a comprehensive back-up plan with detailed procedures. When using a batch back-up system, operations personnel must convert data to a machine-readable format and transport the data to the servicer. This process may require additional personnel (data-entry operators and messengers) and equipment. An institution's contingency plan should include detailed procedures on how to obtain and use the personnel and equipment. Because on-line systems are updated or improved frequently, a batch back-up may not remain compatible. Institution personnel should perform periodic tests of batch and other back-up capabilities to ensure that protection is available and that employees are familiar with the plan.

Institutions should create computerized back-up copies of the institution's critical records and have alternative methods of processing those records. When IT operations are performed outside the institution, both the servicer and the financial institution should have adequate control over the records. Bank management should determine which records are best protected by the servicer and which are best protected internally. Service contracts should outline the servicer's responsibility for storing bank records. If the servicer does not or will not permit specific reference to record retention in the contract, a general reference may be sufficient. The institution should obtain a copy of the servicer's back-up policy and retention procedures, and bank management should thoroughly understand which records are protected by whom and to what extent.

The bank should also review the servicer's software and hardware back-up arrangements. It should review the service provider's contingency plan and results of routine tests of the contingency plan. The review should determine how often data and software back-ups are made, the location of stored materials, and which materials are stored at that site. Management should also determine the availability of software replacement and vendor support, as well as the amount and location of duplicate software documentation. Software replacement and documentation procedures should be developed for both operating and application systems.

Management should review the servicer's hardware back-up arrangements to determine if (1) the servicer has a contract with a national recovery service and, if so, the amount and type of back-up capacity provided under the contract; (2) the servicer has an alternate data center with sufficient capacity and personnel to provide full service if necessary; or (3) multiple processing sites within the same facility are available for disaster-processing problems and if each site has an alternate power supply. The alternate site should be able to provide continued processing of data and transmission of reports.

Contracts or contingency plans should specify the availability of source documentation in the event of a disaster, including insolvency of the servicer. FFIEC interagency issuances and Federal Reserve System policy statements require financial institutions to evaluate the adequacy of a servicer's contingency plan and to ensure that its own contingency plan is compatible with the servicer's plan.

Since the duplication of records may vary from site to site, most organizations develop schedules for automatic retention of records on a case-by-case basis. The only way to ensure sufficient record protection is to continually review the flow of documents, data, and reports. Some records may be available in both hard-copy and machine-readable formats. In addition to determining the types of back-up records, management should determine whether it is possible to re-create current data from older records. Certain records also have uses apart from their value in reconstructing current data, such as meeting institutional and regulatory reporting requirements. These records usually include month-end, quarter-end, and year-end files.

The location of an external data center is another factor to consider when evaluating retention procedures. If the external data center is located in a building adjacent to the institution, the possibility that a disaster may affect both organizations increases. Such a situation may make off-site storage of back-up materials even more important. If, on the other hand, the serviced institution is located far from the data center, physical shipment of both input and output may become necessary. Management should determine if fast, reliable transportation between the two sites is available.

If a major disaster occurs, an alternate facility may not be available to process duplicated machine-readable media. Management should consider remote record storage that would facilitate the manual processing of records, if necessary. Furthermore, microfilming all items before shipment would protect the institution if any items are lost, misplaced, or destroyed. Optical-disk storage, which involves scanning and storing a document electronically, offers another alternative for storage and retrieval of original data after processing has occurred. The FFIEC's *IS Handbook* and related FFIEC and Federal Reserve System issuances are sources of information about planning for unexpected contingencies.

Processing personnel should regularly copy and store critical institution records in an off-site location that is sufficiently accessible to obtain records in a reasonable time period. These records should include data files, programs, operating systems, and related documentation. This also applies to critical data in hard-copy documents. In addition, an inventory

of the stored information should be maintained along with a defined retention period.

## AUDITS

Examiners need to determine the appropriateness of the scope and frequency of audit activities related to information systems and the reliability of internal or third-party audits of servicer-processed work. Furthermore, examiners should review the methods by which the board of directors is apprised of audit findings, recommendations, and corrective actions taken. In reviewing audit activities, examiners should consider the following factors (if applicable):

- the practicality of the financial institution's having an internal IT auditor and, if the institution has an internal IT auditor, the auditor's level of training and experience
- the training and experience of the institution's external auditors
- the audit functions performed by the institution's outside auditors, the servicer, the servicer's outside auditor, and supervisory personnel
- internal IT audit techniques currently being followed

The audit function should review controls and operating procedures that help protect the institution from losses caused by irregularities and willful manipulations of the data processing system. Thus, a regular, comprehensive audit of IT activities is necessary. Additionally, designated personnel at each serviced institution should periodically perform "around-the-computer" audit examinations, such as:

- developing data controls (proof totals, batch totals, document counts, number of accounts, and prenumbered documents) at the institution before submitting data to the servicer and sampling the controls periodically to ensure their accuracy;
- spot-checking reconciliation procedures to ensure that output totals agree with input totals, less any rejects;
- sampling rejected, unpostable, holdover, and suspense items to determine why they cannot be processed and how they were disposed of (to make sure they were properly corrected and re-entered on a timely basis);



- verifying selected master-file information (such as service-charge codes), reviewing exception reports, and cross-checking loan extensions to source documents;
- spot-checking computer calculations, such as the dollar amounts of loan rebates, interest on deposits, late charges, service charges, and past-due loans, to ensure proper calculations;
- tracing transactions to final disposition to ensure audit trails are adequate;
- reviewing source documents to ascertain whether sensitive master-file change requests were given the required supervisory approval;
- assessing the current status of controls by either visiting the servicer or reviewing independent third-party reviews of the servicer;
- reviewing processing procedures and controls; and
- evaluating other audits of the servicer.

In addition, “through-the-computer” audit techniques allow the auditor to use the computer to check data processing steps. Audit software programs are available to test extensions and footings and to prepare verification statements.

Regardless of whether an institution processes data internally or externally, the board of directors must provide an adequate audit program for all automated records. If the institution has no internal IT audit expertise, the nontechnical “around-the-computer” methods will provide minimum coverage, but not necessarily adequate coverage. A comprehensive external IT audit, similar to those discussed in the FFIEC’s *IS Handbook*, should be carried out to supplement nontechnical methods.

## INSURANCE

A financial institution should periodically review its insurance coverage to ensure that the amount of coverage is adequate to cover any exposure that may arise from using an external IT provider. To determine what coverage is needed, the institution should review its internal operations, the transmission or transportation of records or data, and the type of processing performed by the servicer. This review should identify risks to data, namely the accountability for data, at both the user and servicer locations and while in transit. Insurance covering physical disasters, such as fires, floods, and explosions, should be sufficient to cover replacement of the

data processing system. Coverage that protects specialized computer and communications equipment may be more desirable than the coverage provided by regular hazard insurance. Expanded coverage protects against water infiltration, mechanical breakdown, electrical disturbances, changes in temperature, and corrosion. The use of an “agreed-amount” endorsement can provide for full recovery of covered loss.

Bank management should also review the servicer’s insurance coverage to determine if the amounts and types are adequate. Servicer coverage should be similar to what the financial institution would normally purchase if it were performing its data processing internally. Servicer-provided coverage should complement and supplement the bank’s coverage.

If a loss is claimed under the user’s coverage, the user need only prove that a loss occurred to make a claim. However, if the loss is claimed under the servicer’s coverage, the institution must prove that a loss occurred and also that the servicer was responsible for the loss.

Examiners should review the serviced institution’s blanket bond coverage, as well as similar coverage provided by the servicer. The coverage period may be stated in terms of a fixed time period. The loss, the discovery, and the reporting of the loss to the insurer must occur during that stated period. Extended discovery periods are generally available at additional cost if an institution does not renew its bond. The dollar amount of the coverage now represents an aggregate for the stated period. Each claim paid, including the loss, court costs, and legal fees, reduces the outstanding amount of coverage, and recoveries do not reinstate previous levels of coverage. Since coverage extends only to locations stated in the policy, the policy must individually list all offices. Additionally, policies no longer cover certain types of documents in transit.

The bank’s board of directors should be involved in determining insurance coverage since each board member will be acknowledging the terms, conditions, fees, riders, and exclusions of the policy. Insurance companies consider any provided information as a warranty of coverage. Any omission of substantive information could result in voided coverage.

The bank or servicer should consider buying additional coverage. Media-reconstruction policies defray costs associated with recovering data contained on the magnetic media. Media-replacement policies replace blank media. Extra-

expense policies reimburse organizations for expenses incurred over and above the normal cost of operations. In addition, servicers often purchase policies covering unforeseen business interruptions and the liabilities associated with errors and omissions. Both servicer and banking organizations may purchase transit insurance that covers the physical shipment of source documents. Additionally, electronic funds transfer system (EFTS) liability coverage is available for those operations that use electronic transmission.

Several factors may influence an institution's decision to purchase insurance coverage or to self-insure: the cost of coverage versus the probability of occurrence of a loss, the cost of coverage versus the size of the loss of each occurrence, and the cost of coverage versus the cost of correcting a situation that could result in a loss. Some institutions engage risk consultants to evaluate these risks and the costs of insuring against them.

## SERVICE CONTRACTS

### Contract Practices

A poorly written or inadequately reviewed contract can be troublesome for both the serviced financial institution and the servicer. To avoid or minimize contract problems, bank legal counsel who are familiar with the terminology and specific requirements of a data processing contract should review it to protect the institution's interests. Since the contract likely sets the terms for a multiyear understanding between the parties, all items agreed on during negotiations must be included in the final signed contract. Verbal agreements are generally not enforceable, and contracts should include wording such as "no oral representations apply" to protect both parties from future misunderstandings. The contract should also establish baseline performance standards for data processing services and define each party's responsibilities and liabilities, where possible.

Although contracts between financial institutions and external data processing companies are not standardized in a form, they share a number of common elements. For a further discussion of IT contract elements and considerations, see the FFIEC's *IS Handbook*.

Additionally, section 225 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) states, "An [FDIC-] insured depository institution may not enter into a written or oral contract with any person to provide goods, products or services to or for the benefit of such depository institution if the performance of such contract would adversely affect the safety or soundness of the institution." An institution should ascertain during contract negotiations whether the servicer can provide a level of service that meets the needs of the institution over the life of the contract. The institution is also responsible for making sure it accounts for each contract in accordance with GAAP. Regulatory agencies consider contracting for excessive servicing fees and/or failing to properly account for such transactions an unsafe and unsound practice. When entering into service agreements, banks must ensure that the method by which they account for such agreements reflects the substance of the transaction and not merely its form. See FFIEC Supervisory Policy SP-6, "Interagency Statement on EDP Service Contracts."

### Risk of Termination

Many financial institutions have become so dependent on outside data processing servicers that any extended interruption or termination of service would severely disrupt normal operations. Termination of services generally occurs according to the terms of the service contract. Banks may also experience an interruption of services that is caused by a physical disaster to the servicer, such as a fire or flood, or by bankruptcy. The serviced institution must prepare differently for each type of termination. The contract should allow either party to terminate the agreement by notifying the other party 90 to 180 days in advance of the termination date, which should give a serviced institution adequate time to locate and contract with another servicer.

Termination caused by physical disaster occurs infrequently, but it may present the institution with a more serious problem than termination by contract. However, if the servicer has complied with basic industry standards and maintains a proper contingency plan, disruption of services to users will ordinarily be minimal. The contingency plan must require the servicer to

maintain current data files and programs at an alternate site and arrange for back-up processing time with another data center. At a minimum, these provisions should allow the servicer to process the most important data applications. Since equipment vendors can often replace damaged machines within a few days, the servicer should be able to resume processing with little delay. The servicer, not the serviced institution, is responsible for the major provisions of its back-up contingency plan. However, the institution must have a plan that complements the servicer's.

Termination caused by bankruptcy of the servicer is potentially the most devastating to a serviced institution. There may not be advance notice of termination or an effective contingency plan (because servicer personnel may not be available). In this situation, the serviced institution is responsible for finding an alternate processing site.

Although user institutions can ordinarily obtain data files from a bankrupt servicer with little trouble, the programs (source code) and documentation required to process those files are normally owned by the servicer and are not available to the user institutions. These programs are often the servicer's only significant assets. Therefore, a creditor of a bankrupt servicer, in an attempt to recover outstanding debts, will seek to attach those assets and further limit their availability to user institutions. The bankruptcy court may provide remedies to the user institutions, but only after an extended length of time.

An escrow agreement is an alternative to giving vendors sole control of the source code. In this agreement, which should either be part of the service contract or a separate document, the financial institution would receive the right to access source programs under certain conditions, such as discontinued product support or the financial insolvency of the vendor. A third party would retain these programs and related documents in escrow. Periodically, the financial institution should determine that the source code maintained in escrow is up-to-date, for example, an independent party should verify the version number of the software. Without an escrow agreement, a serviced institution has two alternatives: (1) pay off the creditor and hire outside specialists to operate the center or (2) convert data files to another servicer. Either alternative is likely to be costly and cause severe operating delays.

Institutions should normally determine the financial viability of its servicer annually. Once the review is complete, management must report the results to the board of directors or a designated committee. At a minimum, management's review should contain a careful analysis of the servicer's annual financial statement. Management may also use other sources of information to determine a servicer's condition, such as investment analyst reports and bond ratings. Reports of independent auditors and examination reports for certain service providers obtainable from appropriate regulatory agencies may contain useful information.

## AUTOMATED CLEARINGHOUSE

Automated clearinghouses (ACHs) form a nationwide electronic payments system used by a large number of depository institutions and corporations. ACH rules and regulations are established by the National Automated Clearing House Association (NACHA) and the local ACH associations, and they are referenced in the ACH operating circulars of the Federal Reserve Banks.

ACH is a value-based system that supports both credit and debit transactions. In ACH credit transactions, funds flow from the depository institution originating the transaction to the institutions receiving the transactions. Examples of credit payments include direct deposits of payroll, dividend and interest payments, Social Security payments, and corporate payments to contractors and vendors. In a debit transaction, funds flow from the depository institutions receiving the transaction instructions to the institution originating the transaction. Examples of ACH debit transactions include collection of insurance premiums, mortgage and loan payments, consumer bill payments, and transactions to facilitate corporate cash management. ACH transactions are deposited in batches at Federal Reserve Banks (or private-sector ACH processors) for processing one or two business days before the settlement date. These transactions are processed and delivered to the receiving institutions through the nightly processing cycle for a given day.

ACH transactions continue to grow significantly. Additional uses of the ACH continue to be developed as depository institutions, corpo-

rations, and consumers realize its efficiency and low cost compared with large-dollar payments systems and check payments. One area of growth is the use of debit transactions for the collection of large payments due to the originator, such as the cash concentration of a company's nationwide branch or subsidiary accounts into one central account and other recurring contractual payments.

While several organizations can be involved in processing ACH transactions, the Federal Reserve System is the principal ACH processor. For the Federal Reserve ACH system, depository institutions send ACH transactions to and receive ACH transactions from one of the Federal Reserve processing sites via a communications system linking each location. Access may be by direct computer interface or intelligent terminal connections.

As with any funds-transfer system, the ACH system has inherent risks, including error, credit risk, and fraud. When reviewing ACH activities, examiners should evaluate the following:

- agreements covering delivery and settlement arrangements maintained by the depository institution as an originator or receiver of ACH transactions
- monitoring of the institution's and customer's intraday positions
- balancing procedures of ACH transactions processed
- the credit policy and effectiveness of procedures to control intraday and overnight overdrafts, resulting from extensions of credit to an ACH customer, to cover the value of credit transfers originated (Since ACH transactions may be originated one or two days before the settlement date, the originating institution is exposed to risk from the time it submits ACH credit transfers to the ACH processor to the time its customer funds those transfers.)
- uncollected-funds controls and the related credit policy for deposits created through ACH debit transactions (ACH debits can be returned for insufficient funds in the payor's account or for other reasons, such as a court order.)
- exception reports (that is, large-item and new-account reports)
- control procedures for terminals through which additions, deletions, and other forms of maintenance could be made to customer databases
- the retention of all entries, return entries, and adjustment entries transmitted to and received

from the ACH for a period of six years after the date of transmittal

## RETAIL FUNDS-TRANSFER SYSTEMS

Automation has enabled banks to electronically perform many retail banking functions formerly handled manually by tellers, bookkeepers, data-entry clerks, and other banking personnel. Accordingly, the need for physical banking facilities and related staff has been reduced. Electronic funds transfer (EFT) and related banking services have also brought access to and control of accounts closer to the consumer through the use of widely distributed unmanned terminals and merchant facilities. EFT-related risk to a financial institution for individual customer transactions is generally low, since the transactions are usually for relatively small amounts. However, weaknesses in controls that could lead to incorrect or improper use of several accounts could lead to significant losses or class action suits against a financial institution. Examinations of retail EFT facilities should focus on the potential large-scale risks of a given product. Examples of retail EFT systems include automated teller machines, point-of-sale networks, debit and "smart" cards, and home banking.

### Automated Teller Machines

An automated teller machine (ATM) is a terminal that is capable of performing many routine banking services for the customer. ATMs handle deposits, transfers between savings and checking accounts, balance inquiries, withdrawals, small short-term loans, and loan payments. ATMs may also handle other transactions, such as cash advances on credit cards, statement printing, and postage-stamp dispensing. ATMs usually operate 24 hours a day and are located not only on bank premises but in other locations, such as shopping malls and businesses. Daily withdrawals are usually, and should be, limited to relatively small amounts (\$200 to \$500). Deposits are processed in the same manner as if they were handled by a teller. ATMs are generally activated through the use of a plastic card encoded with a machine-readable customer identification number and the customer's entry of a

corresponding personal identification number (PIN). Some financial institutions may refer to this identification number as the personal identification code (PIC).

ATMs operate in either off-line or on-line mode. Off-line transactions are those that occur when the customer's account balance is not available for verification. This situation can be the result of telecommunication problems between the financial institution and the ATM network. In addition, an off-line transaction can occur when a customer's account balance is not available because the financial institution is updating its files. Financial institutions usually update their files during low-volume periods. In either case, transactions are usually approved up to the daily withdrawal limit, which is a risk to the bank because a customer can withdraw more than is available in the account. On-line systems are directly connected to a financial institution's computer system and the corresponding customer account information. The computer processes each transaction immediately and provides immediate account-balance verification. With either system, a card is normally captured (kept by the ATM) if misuse is indicated (for example, the card has been reported stolen or too many attempts have been made with an invalid PIN).

Financial institutions are usually members of several ATM networks, which can be regional and national. Through these networks, separate institutions allow each other's customers to use their ATM machines. This is known as an interchange system. To be involved in an interchange system, a financial institution must either be an owner or member of the ATM network.

Fraud, robbery, and malfunction are the major risks of ATMs. The use of plastic cards and PINs are a deterrent, but there is still the risk that an unauthorized individual may obtain them. Customers may even be physically accosted while making withdrawals or deposits at ATM locations. Institutions have decreased this risk by installing surveillance cameras and access-control devices. For example, the ATM card can be used as an access-control device, unlocking the door to a separate ATM enclosure and relocking it after the customer has entered. Fraud may also result from risks associated with the issuance of ATM cards, the capture of cards, and the handling of customer PINs. Appropriate controls are needed to prevent the financial institution's personnel from unauthorized access to unissued cards, PINs, and captured cards.

## Point-of-Sale Systems

A point-of-sale (POS) system transaction is defined as an electronic transfer of funds from a customer's checking or savings account to a merchant's account to pay for goods or services. Transactions are initiated from POS terminals located in department stores, supermarkets, gasoline stations, and other retail outlets. In an electronic POS system, a customer pays for purchases using a plastic card (such as an ATM, credit, or debit card). The store clerk enters the payment information into the POS terminal, and the customer verifies the transaction by entering a PIN. This results in a debit to the customer's account and a credit to the merchant's account.

POS transactions may be processed through either single-institution unshared systems or multi-institution shared networks. Participants in a shared system settle daily, on a net transaction basis, between each other. In unshared systems, the merchants and customers have accounts with the same financial institution. Thus, the need to settle between banks is eliminated.

As with other EFT systems, POS transactions are subject to the risk of loss from fraud, mistakes, and system malfunction. POS fraud is caused by stolen cards and PINs, counterfeit cards, and unauthorized direct computer access. The system is also susceptible to errors such as debiting or crediting an account by too much or too little, or entering unauthorized transactions. For the most part, POS systems usually deal with these risks by executing bank-merchant and bank-customer contracts that delineate each party's liabilities and responsibilities. Also, consumers are protected by state and federal statutes limiting their liability if they give notice of a lost, stolen, or mutilated card within a specified time period. Other risks inherent in POS systems are computer malfunction or downtime. Financial institutions offering POS services should provide for back-up of their records through adequate contingency planning. Internal control guidelines for POS systems should address the following:

- confidentiality and security of customer-account information, including protection of PINs
- maintenance of contracts between banks and merchants, customers and banks, and banks and networks
- policies and procedures for credit and check

- authorization, floor limits, overrides, and settlement and balancing
- maintenance of transaction journals to provide an adequate audit trail
- generation and review of daily exception reports with provisions for follow-up of exception items
- provisions for back-up and contingency planning
- physical security surrounding POS terminals

## Internal Controls for Retail EFT Systems

Regardless of the EFT system employed, financial institutions should ensure that adequate internal controls are in place to minimize errors, discourage fraud, and provide an adequate audit trail. Recommended internal-control guidelines for all systems include:

- establishing measures to establish proper customer identification (such as PINs) and maintain their confidentiality
- installing a dependable file-maintenance and retention system to trace transactions
- producing, reviewing, and maintaining exception reports to provide an audit trail

The most critical element of EFT systems is the need for undisputed identification of the customer. Particular attention should be given to the customer-identification systems. The most common control is the issuance of a unique PIN that is used in conjunction with a plastic card or, for noncard systems, an account number. The following PIN control guidelines, as recommended by the American Bankers Association, are encouraged.

### *Storage:*

- PINs should not be stored on other source instruments (for example, plastic cards).
- Unissued PINs should never be stored before they are issued. They should be calculated when issued, and any temporary computer storage areas used in the calculation should be cleared immediately after use.
- PINs should be encrypted on all files and databases.

### *Delivery:*

- PINs should not appear in printed form where

they can be associated with customers' account numbers.

- Bank personnel should not have the capability to retrieve or display customers' PIN numbers.
- All the maintenance to PINs stored in databases should be restricted. Console logs and security reports should be reviewed to determine any attempts to subvert the PIN security system.
- PIN mailers should be processed and delivered with the same security accorded the delivery of bank cards to cardholders. (They should never be mailed to a customer together with the card).

### *Usage:*

- The PIN should be entered only by the cardholder and only in an environment that deters casual observation of entries.
- The PIN should never be transmitted in unencrypted form.
- PIN systems should record the number of unsuccessful PIN entries and should restrict access to a customer's account after a limited number of attempts.
- If a PIN is forgotten, the customer should select a new one rather than have bank personnel retrieve the old one, unless the bank has the ability to generate and mail a hard copy of the PIN directly to the customer without giving bank personnel the ability to view the PIN.

### *Control and security:*

- Systems should be designed, tested, and controlled to preclude retrieval of stored PINs in any form.
- Application programs and other software containing formulas, algorithms, and data used to calculate PINs must be subject to the highest level of access control for security purposes.
- Any data-recording medium, for example, magnetic tape and removable disks, used in the process of assigning, distributing, calculating, or encrypting PINs must be cleared immediately after use.
- Employees with access to PIN information must be subject to security clearance and must be covered by an adequate surety bond.

*System design:*

- PIN systems should be designed so that PINs can be changed without reissuing cards.
- PINs used on interchange systems should be designed so that they can be used or changed without any modification to other participants' systems.
- Financial institutions electing to use encryption as a security technique for bank card systems are strongly encouraged to consider the data encryption standards established by the National Institute of Standards and Technology.

In addition, institutions should consider controls over other aspects of the process. Control guidelines appropriate for plastic cards include those covering procurement, embossing or encoding, storage, and mailing. Controls over terminal sharing and network switching are also appropriate. Institutions should address backup procedures and practices for retail funds-transfer systems and insurance coverage for these activities.

## APPENDIX A—RISK MANAGEMENT OF OUTSOURCED TECHNOLOGY SERVICES

The following guidance was issued by the Federal Financial Institutions Examination Council on November 28, 2000. (See SR-00-17.)

### Purpose and Background

This statement focuses on the risk-management process of identifying, measuring, monitoring, and controlling the risks associated with outsourcing technology services.<sup>1</sup> Financial institutions should consider the guidance outlined in this statement and the attached appendix in managing arrangements with their technology service providers.<sup>2</sup> While this guidance covers a

1. The FFIEC Information Systems Examination Handbook is a reference source that contains further discussion and explanation of a number of concepts addressed in this FFIEC guidance.

2. Technology service providers encompass a broad range of entities including but not limited to affiliated entities, nonaffiliated entities, and alliances of companies providing

broad range of issues that financial institutions should address, each financial institution should apply those elements based on the scope and importance of the outsourced services as well as the risk to the institution from the services.

Financial institutions increasingly rely on services provided by other entities to support an array of technology-related functions. While outsourcing to affiliated or nonaffiliated entities can help financial institutions manage costs, obtain necessary expertise, expand customer product offerings, and improve services, it also introduces risks that financial institutions should address. This guidance covers four elements of a risk-management process: risk assessment, selection of service providers, contract review, and monitoring of service providers.<sup>3</sup>

### Risk Assessment

The board of directors and senior management are responsible for understanding the risks associated with outsourcing arrangements for technology services and ensuring that effective risk-management practices are in place. As part of this responsibility, the board and management should assess how the outsourcing arrangement will support the institution's objectives and strategic plans and how the service provider's relationship will be managed. Without an effective risk-assessment phase, outsourcing technology services may be inconsistent with the institution's strategic plans, too costly, or introduce unforeseen risks.

Outsourcing of information and transaction processing and settlement activities involves risks that are similar to the risks that arise when these functions are performed internally. Risks include threats to security, availability and integrity of systems and resources, confidentiality of information, and regulatory compliance. In addition, the nature of the service provided, such as bill payment, funds transfer, or emerging

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products and services. This may include but is not limited to core processing; information and transaction processing and settlement activities that support banking functions such as lending, deposit-taking, funds transfer, fiduciary, or trading activities; Internet-related services; security monitoring; systems development and maintenance; aggregation services; digital certification services; and call centers.

3. The federal banking agencies have authority to regulate and examine services provided to insured depository institutions under 12 USC 1867(c), 12 USC 1786(a), and 12 USC 1464(d)(7).

electronic services, may result in entities performing transactions on behalf of the institution, such as collection or disbursement of funds, that can increase the levels of credit, liquidity, transaction, and reputation risks.<sup>4</sup>

Management should consider additional risk-management controls when services involve the use of the Internet. The broad geographic reach, ease of access, and anonymity of the Internet require close attention to maintaining secure systems; intrusion detection and reporting systems; and customer authentication, verification, and authorization. Institutions should also understand that the potential risks introduced are a function of a system's structure, design, and controls and not necessarily the volume of activity.

An outsourcing risk assessment should consider the following:

- strategic goals, objectives, and business needs of the financial institution
- ability to evaluate and oversee outsourcing relationships
- importance and criticality of the services to the financial institution
- defined requirements for the outsourced activity
- necessary controls and reporting processes
- contractual obligations and requirements for the service provider
- contingency plans, including availability of alternative service providers, costs, and resources required to switch service providers
- ongoing assessment of outsourcing arrangements to evaluate consistency with strategic objectives and service-provider performance
- regulatory requirements and guidance for the business lines affected and technologies used

## Due Diligence in Selecting a Service Provider

Once the institution has completed the risk assessment, management should evaluate service providers to determine their ability, both operationally and financially, to meet the institution's needs. Management should convey the institution's needs, objectives, and necessary

controls to the potential service provider. Management also should discuss provisions that the contract should contain. The appendix to this statement contains some specific factors for management to consider in selecting a service provider.

## Contract Issues

Contracts between the institution and service provider should take into account business requirements and key risk factors identified during the risk-assessment and due-diligence phases. Contracts should be clearly written and sufficiently detailed to provide assurances for performance, reliability, security, confidentiality, and reporting. Management should consider whether the contract is flexible enough to allow for changes in technology and the financial institution's operations. Appropriate legal counsel should review contracts prior to signing.

Institutions may encounter situations where service providers cannot or will not agree to terms that the institution requests to manage the risk effectively. Under these circumstances, institutions should either not contract with that provider or supplement the service provider's commitments with additional risk-mitigation controls. The appendix to this statement contains some specific considerations for management in contracting with a service provider.

## Service-Provider Oversight

Institutions should implement an oversight program to monitor each service provider's controls, condition, and performance. Responsibility for the administration of the service-provider relationship should be assigned to personnel with appropriate expertise to monitor and manage the relationship. The number of personnel, functional responsibilities, and the amount of time devoted to oversight activities will depend, in part, on the scope and complexity of the services outsourced. Institutions should document the administration of the service-provider relationship. Documenting the process is important for contract negotiations, termination issues, and contingency planning. The appendix to this statement contains some specific factors to consider regarding oversight of the service provider.

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4. For example, emerging electronic services may include aggregation. Aggregation is a service that gathers online account information from many web sites and presents that information in a consolidated format to the customer.



## Summary

The board of directors and management are responsible for ensuring adequate risk-mitigation practices are in place for effective oversight and management of outsourcing relationships. Financial institutions should incorporate an outsourcing risk-management process that includes a risk assessment to identify the institution's needs and requirements; proper due diligence to identify and select a provider; written contracts that clearly outline duties, obligations, and responsibilities of the parties involved; and ongoing oversight of outsourcing technology services.

## Appendix—Risk Management of Outsourced Technology Services

### *Due Diligence in Selecting a Service Provider*

Some of the factors that institutions should consider when performing due diligence in selecting a service provider are categorized and listed below. Institutions should review the service provider's due-diligence process for any of its significant supporting agents (i.e., subcontractors, support vendors, and other parties). Depending on the services being outsourced and the level of in-house expertise, institutions should consider whether to hire or consult with qualified independent sources. These sources include consultants, user groups, and trade associations that are familiar with products and services offered by third parties. Ultimately, the depth of due diligence will vary depending on the scope and importance of the outsourced services as well as the risk to the institution from these services.

#### *Technical and industry expertise.*

- Assess the service provider's experience and ability to provide the necessary services and supporting technology for current and anticipated needs.
- Identify areas where the institution would have to supplement the service provider's expertise to fully manage risk.
- Evaluate the service provider's use of third parties or partners that would be used to support the outsourced operations.

- Evaluate the experience of the service provider in providing services in the anticipated operating environment.
- Consider whether additional systems, data conversions, and work are necessary.
- Evaluate the service provider's ability to respond to service disruptions.
- Contact references and user groups to learn about the service provider's reputation and performance.
- Evaluate key service-provider personnel that would be assigned to support the institution.
- Perform on-site visits, where necessary, to better understand how the service provider operates and supports its services.

#### *Operations and controls.*

- Determine adequacy of the service provider's standards, policies, and procedures relating to internal controls, facilities management (e.g., access requirements, sharing of facilities, etc.), security (e.g., systems, data, equipment, etc.), privacy protections, maintenance of records, business-resumption contingency planning, systems development and maintenance, and employee background checks.
- Determine if the service provider provides sufficient security precautions, including, when appropriate, firewalls, encryption, and customer-identity authentication, to protect institution resources as well as detect and respond to intrusions.
- Review audit reports of the service provider to determine whether the audit scope, internal controls, and security safeguards are adequate.
- Evaluate whether the institution will have complete and timely access to its information maintained by the provider.
- Evaluate the service provider's knowledge of regulations that are relevant to the services they are providing (e.g., Regulation E, privacy and other consumer protection regulations, Bank Secrecy Act, etc.).
- Assess the adequacy of the service provider's insurance coverage including fidelity, fire, liability, data losses from errors and omissions, and protection of documents in transit.

#### *Financial condition.*

- Analyze the service provider's most recent audited financial statements and annual report as well as other indicators (e.g., publicly

traded bond ratings), if available.

- Consider factors such as how long the service provider has been in business and the service provider's market share for a given service and how it has fluctuated.
- Consider the significance of the institution's proposed contract on the service provider's financial condition.
- Evaluate technological expenditures. Is the service provider's level of investment in technology consistent with supporting the institution's activities? Does the service provider have the financial resources to invest in and support the required technology?

### *Contract Issues*

Some considerations for contracting with service providers are discussed below. This listing is not all-inclusive, and the institution may need to evaluate other considerations based on its unique circumstances. The level of detail and relative importance of contract provisions varies with the scope and risks of the services outsourced.

*Scope of service.* The contract should clearly describe the rights and responsibilities of parties to the contract. Considerations include—

- time frames and activities for implementation and assignment of responsibility (implementation provisions should take into consideration other existing systems or interrelated systems to be developed by different service providers (e.g., an Internet banking system being integrated with existing core applications or systems customization));
- services to be performed by the service provider including duties such as software support and maintenance, training of employees, or customer service;
- obligations of the financial institution;
- the contracting parties' rights in modifying existing services performed under the contract; and
- guidelines for adding new or different services and for contract renegotiation.

*Performance standards.* Institutions should generally include performance standards defining minimum service-level requirements and remedies for failure to meet standards in the contract. For example, common service-level met-

rics include percent system uptime, deadlines for completing batch processing, or number of processing errors. Industry standards for service levels may provide a reference point. The institution should periodically review overall performance standards to ensure consistency with its goals and objectives.

*Security and confidentiality.* The contract should address the service provider's responsibility for security and confidentiality of the institution's resources (e.g., information, hardware). The agreement should prohibit the service provider and its agents from using or disclosing the institution's information, except as necessary to or consistent with providing the contracted services, to protect against unauthorized use (e.g., disclosure of information to institution competitors). If the service provider receives nonpublic personal information regarding the institution's customers, the institution should notify the service provider to assess the applicability of the privacy regulations. Institutions should require the service provider to fully disclose breaches in security resulting in unauthorized intrusions into the service provider that may materially affect the institution or its customers. The service provider should report to the institution when material intrusions occur, the effect on the institution, and corrective action to respond to the intrusion.

*Controls.* Consideration should be given to contract provisions addressing control over operations such as—

- internal controls to be maintained by the service provider;
- compliance with applicable regulatory requirements;
- records to be maintained by the service provider;
- access to the records by the institution;
- notification by the service provider to the institution and the institution's approval rights regarding material changes to services, systems, controls, key project personnel allocated to the institution, and new service locations;
- setting and monitoring of parameters relating to any financial functions, such as payments processing and any extensions of credit on behalf of the institution; and
- insurance coverage to be maintained by the service provider.

**Audit.** The institution should generally include in the contract the types of audit reports the institution is entitled to receive (e.g., financial, internal control, and security reviews). The contract can specify audit frequency, cost to the institution associated with the audits if any, as well as the rights of the institution and its agencies to obtain the results of the audits in a timely manner. The contract may also specify rights to obtain documentation regarding the resolution of audit-disclosed deficiencies and inspect the processing facilities and operating practices of the service provider. Management should consider, based upon the risk-assessment phase, the degree to which independent internal audits completed by service-provider audit staff can be used and the need for external audits and reviews (e.g., SAS 70 type I and II reviews).<sup>5</sup>

For services involving access to open networks, such as Internet-related services, special attention should be paid to security. The institution may wish to include contract terms requiring periodic audits to be performed by an independent party with sufficient expertise. These audits may include penetration testing, intrusion detection, and firewall configuration. The institution should receive sufficiently detailed reports on the findings of these ongoing audits to adequately assess security without compromising the service provider's security. It can be beneficial to both the service provider and the institution to contract for such ongoing tests on a coordinated basis given the number of institutions that may contract with the service provider and the importance of the test results to the institution.

**Reports.** Contractual terms should discuss the frequency and type of reports the institution will receive (e.g., performance reports, control audits, financial statements, security, and business-resumption testing reports). Guidelines and fees for obtaining custom reports should also be discussed.

**Business-resumption and contingency plans.** The contract should address the service provider's responsibility for backup and record protection,

including equipment, program and data files, and maintenance of disaster-recovery and contingency plans. Responsibilities should include testing of the plans and providing results to the institution. The institution should consider interdependencies among service providers when determining business-resumption testing requirements. The service provider should provide the institution with operating procedures the service provider and institution are to implement in the event business-resumption contingency plans are implemented. Contracts should include specific provisions for business-recovery time frames that meet the institution's business requirements. The institution should ensure that the contract does not contain any provisions that would excuse the service provider from implementing its contingency plans.

**Subcontracting and multiple-service-provider relationships.** Some service providers may contract with third parties in providing services to the financial institution. To provide accountability, it may be beneficial for the financial institution to seek an agreement with and designate a primary contracting service provider. The institution may want to consider including a provision specifying that the contracting service provider is responsible for the service provided to the institution regardless of which entity is actually conducting the operations. The institution may also want to consider including notification and approval requirements regarding changes to the service provider's significant subcontractors.

**Cost.** The contract should fully describe fees and calculations for base services, including any development, conversion, and recurring services, as well as any charges based upon volume of activity and for special requests. Cost and responsibility for purchase and maintenance of hardware and software may also need to be addressed. Any conditions under which the cost structure may be changed should be addressed in detail including limits on any cost increases.

**Ownership and license.** The contract should address ownership and allowable use by the service provider of the institution's data, equipment/hardware, system documentation, system and application software, and other intellectual property rights. Other intellectual property rights may include the institution's name and logo, its trademark or copyrighted material,

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5. AICPA Statement of Auditing Standards 70, "Reports of Processing of Transactions by Service Organizations," known as SAS 70 reports, are one commonly used form of external review. Type I SAS 70 reports review the service provider's policies and procedures. Type II SAS 70 reports provide tests of actual controls against policies and procedures.

domain names, web site designs, and other work products developed by the service provider for the institution. The contract should not contain unnecessary limitations on the return of items owned by the institution. Institutions that purchase software should consider establishing escrow agreements. These escrow agreements may provide for the following: institution access to source programs under certain conditions (e.g., insolvency of the vendor), documentation of programming and systems, and verification of updated source code.

*Duration.* Institutions should consider the type of technology and current state of the industry when negotiating the appropriate length of the contract and its renewal periods. While there can be benefits to long-term technology contracts, certain technologies may be subject to rapid change and a shorter-term contract may prove beneficial. Similarly, institutions should consider the appropriate length of time required to notify the service provider of the institutions' intent not to renew the contract prior to expiration. Institutions should consider coordinating the expiration dates of contracts for interrelated services (e.g., web site, telecommunications, programming, network support) so that they coincide, where practical. Such coordination can minimize the risk of terminating a contract early and incurring penalties as a result of necessary termination of another related service contract.

*Dispute resolution.* The institution should consider including in the contract a provision for a dispute-resolution process that attempts to resolve problems in an expeditious manner as well as provide for continuation of services during the dispute-resolution period.

*Indemnification.* Indemnification provisions generally require the financial institution to hold the service provider harmless from liability for the negligence of the institution and vice versa. These provisions should be reviewed to reduce the likelihood of potential situations in which the institution may be liable for claims arising as a result of the negligence of the service provider.

*Limitation of liability.* Some service-provider standard contracts may contain clauses limiting the amount of liability that can be incurred by the service provider. If the institution is consid-

ering such a contract, consideration should be given to whether the damage limitation bears an adequate relationship to the amount of loss the financial institution might reasonably experience as a result of the service provider's failure to perform its obligations.

*Termination.* The extent and flexibility of termination rights sought can vary depending upon the service. Contracts for technologies subject to rapid change, for example, may benefit from greater flexibility in termination rights. Termination rights may be sought for a variety of conditions including change in control (e.g., acquisitions and mergers), convenience, substantial increase in cost, repeated failure to meet service levels, failure to provide critical services, bankruptcy, company closure, and insolvency.

Institution management should consider whether or not the contract permits the institution to terminate the contract in a timely manner and without prohibitive expense (e.g., reasonableness of cost or penalty provisions). The contract should state termination and notification requirements with time frames to allow the orderly conversion to another provider. The contract must provide for return of the institution's data, as well as other institution resources, in a timely manner and in machine-readable format. Any costs associated with transition assistance should be clearly stated.

*Assignment.* The institution should consider contract provisions that prohibit assignment of the contract to a third party without the institution's consent, including changes to subcontractors.

### *Oversight of Service Provider*

Some of the oversight activities management should consider in administering the service-provider relationship are categorized and listed below. The degree of oversight activities will vary depending upon the nature of the services outsourced. Institutions should consider the extent to which the service provider conducts similar oversight activities for any of its significant supporting agents (i.e., subcontractors, support vendors, and other parties) and the extent to which the institution may need to perform oversight activities on the service provider's significant supporting agents.

*Monitor financial condition and operations.*

- Evaluate the service provider's financial condition periodically.
  - Ensure that the service provider's financial obligations to subcontractors are being met in a timely manner.
  - Review audit reports (e.g., SAS 70 reviews, security reviews) as well as regulatory examination reports, if available, and evaluate the adequacy of the service provider's systems and controls including resource availability, security, integrity, and confidentiality.<sup>6</sup>
  - Follow up on any deficiencies noted in the audits and reviews of the service provider.
  - Periodically review the service provider's policies relating to internal controls, security, systems development and maintenance, and backup and contingency planning to ensure they meet the institution's minimum guidelines, contract requirements, and are consistent with the current market and technological environment.
  - Review access control reports for suspicious activity.
  - Monitor changes in key service-provider project personnel allocated to the institution.
  - Review and monitor the service provider's insurance policies for effective coverage.
  - Perform on-site inspections in conjunction with some of the reviews performed above, where practicable and necessary.
  - Sponsor coordinated audits and reviews with other client institutions.
- Review system-update procedures to ensure appropriate change controls are in effect and ensure authorization is established for significant system changes.
  - Evaluate the provider's ability to support and enhance the institution's strategic direction including anticipated business-development goals and objectives, service-delivery requirements, and technology initiatives.
  - Determine adequacy of training provided to financial institution employees.
  - Review customer complaints on the products and services provided by the service provider.
  - Periodically meet with contract parties to discuss performance and operational issues.
  - Participate in user groups and other forums.

*Monitor contract compliance and revision needs.*

- Review invoices to ensure proper charges for services rendered, the appropriateness of rate changes, and new service charges.
- Periodically review the service provider's performance relative to service-level agreements, determine whether other contractual terms and conditions are being met, and whether any revisions to service-level expectations or other terms are needed given changes in the institution's needs and technological developments.
- Maintain documents and records regarding contract compliance, revision, and dispute resolution.

*Assess quality of service and support.*

- Regularly review reports documenting the service provider's performance. Determine if the reports are accurate and allow for a meaningful assessment of the service provider's performance.
- Document and follow up on any problem in service in a timely manner. Assess service-provider plans to enhance service levels.

*Maintain business-resumption contingency plans.*

- Review the service provider's business-resumption contingency plans to ensure that any services considered mission critical for the institution can be restored within an acceptable time frame.
- Review the service provider's program for contingency-plan testing. For many critical services, annual or more frequent tests of the contingency plan are typical.
- Ensure service-provider interdependencies are considered for mission-critical services and applications.

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6. Some services provided to insured depository institutions by service providers are examined by the FFIEC member agencies. Regulatory examination reports, which are only available to clients/customers of the service provider, may contain information regarding a service provider's operations. However, regulatory reports are not a substitute for a financial institution's due diligence in oversight of the service provider.

## APPENDIX B—INTERAGENCY GUIDELINES ESTABLISHING INFORMATION SECURITY STANDARDS

Sections II and III of the information security standards are provided below. For more information, see the Interagency Guidelines Establishing Information Security Standards, in Regulation H, section 208, appendix D-2 (12 CFR 208, appendix D-2). The guidelines were previously titled Interagency Guidelines Establishing Standards for Safeguarding Customer Information. The information security standards were amended, effective July 1, 2005, to implement section 216 of the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act). To address the risks associated with identity theft, the amendments generally require financial institutions to develop, implement, and maintain, as part of their existing information security program, appropriate measures to properly dispose of consumer information derived from consumer reports. The term *consumer information* is defined in the revised rule.

### II. Standards for Safeguarding Customer Information

#### A. Information Security Program

Each bank is to implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the size and complexity of the bank and the nature and scope of its activities. While all parts of the bank are not required to implement a uniform set of policies, all elements of the information security program are to be coordinated. A bank is also to ensure that each of its subsidiaries is subject to a comprehensive information security program. The bank may fulfill this requirement either by including a subsidiary within the scope of the bank's comprehensive information security program or by causing the subsidiary to implement a separate comprehensive information security program in accordance with the standards and procedures in sections II and III that apply to banks.

#### B. Objectives

A bank's information security program shall be designed to—

1. ensure the security and confidentiality of customer information;
2. protect against any anticipated threats or hazards to the security or integrity of such information;
3. protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer; and
4. ensure the proper disposal of customer information and consumer information.

### III. Development and Implementation of Information Security Program

#### A. Involve the Board of Directors

The board of directors or an appropriate committee of the board of each bank is to—

1. approve the bank's written information security program; and
2. oversee the development, implementation, and maintenance of the bank's information security program, including assigning specific responsibility for its implementation and reviewing reports from management.

#### B. Assess Risk

Each bank is to—

1. identify reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems;
2. assess the likelihood and potential damage of these threats, taking into consideration the sensitivity of customer information;
3. assess the sufficiency of policies, procedures, customer information systems, and other arrangements in place to control risks; and
4. ensure the proper disposal of customer information and consumer information.



### C. Manage and Control Risk

Each bank is to—

1. Design its information security program to control the identified risks, commensurate with the sensitivity of the information as well as the complexity and scope of the bank's activities. Each bank must consider whether the following security measures are appropriate for the bank and, if so, adopt those measures the bank concludes are appropriate:
  - a. access controls on customer information systems, including controls to authenticate and permit access only to authorized individuals and controls to prevent employees from providing customer information to unauthorized individuals who may seek to obtain this information through fraudulent means
  - b. access restrictions at physical locations containing customer information, such as buildings, computer facilities, and records storage facilities to permit access only to authorized individuals
  - c. encryption of electronic customer information, including while in transit or in storage on networks or systems to which unauthorized individuals may have access
  - d. procedures designed to ensure that customer information system modifications are consistent with the bank's information security program
  - e. dual control procedures, segregation of duties, and employee background checks for employees with responsibilities for or access to customer information
  - f. monitoring systems and procedures to detect actual and attempted attacks on or intrusions into customer information systems
  - g. response programs that specify actions to be taken when the bank suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies
  - h. measures to protect against destruction, loss, or damage of customer information due to potential environmental hazards, such as fire and water damage or technological failures
2. Train staff to implement the bank's information security program.
3. Regularly test the key controls, systems, and

procedures of the information security program. The frequency and nature of such tests should be determined by the bank's risk assessment. Tests should be conducted or reviewed by independent third parties or staff independent of those that develop or maintain the security programs.

4. Develop, implement, and maintain, as part of its information security program, appropriate measures to properly dispose of customer information and consumer information in accordance with each of the requirements in this section III.

### D. Oversee Service-Provider Arrangements

Each bank is to—

1. exercise appropriate due diligence in selecting its service providers;
2. require its service providers by contract to implement appropriate measures designed to meet the objectives of the information security standards; and
3. where indicated by the bank's risk assessment, monitor its service providers to confirm that they have satisfied their obligations with regard to the requirements for overseeing provider arrangements. As part of this monitoring, a bank should review audits, summaries of test results, or other equivalent evaluations of its service providers.

### E. Adjust the Program

Each bank is to monitor, evaluate, and adjust, as appropriate, the information security program in light of any relevant changes in technology, the sensitivity of its customer information, internal or external threats to information, and the bank's own changing business arrangements, such as mergers and acquisitions, alliances and joint ventures, outsourcing arrangements, and changes to customer information systems.

### F. Report to the Board

Each bank is to report to its board or an appropriate committee of the board at least annually. This report should describe the overall

status of the information security program and the bank's compliance with the information security standards. The reports should discuss material matters related to its program, addressing issues such as risk assessment; risk management and control decisions; service-provider arrangements; results of testing; security breaches or violations and management's responses; and

recommendations for changes in the information security program.

*G. Implement the Standards*

(For the effective dates, see 12 CFR 208, appendix D-2, section III.G.)



# Information Technology

## Examination Objectives

Effective date October 2008

## Section 4060.2

1. To explicitly consider IT when developing risk assessments and supervisory plans.
2. To assess the types and levels of risks associated with information technology.
3. To exercise appropriate judgment in determining the level of review, given the characteristics, size, and business activities of the organization.
4. To develop a broad understanding of the organization's approach, strategy, and structure for IT activities within and across business lines.
5. To assess the adequacy of IT architecture and the ability of the current infrastructure to meet operating objectives, including the effective integration of systems and sources of data.
6. To assess the adequacy of the system of controls to safeguard the integrity of the data processed in critical information systems.
7. To determine if the board has developed, implemented, and tested contingency plans that will ensure the continued operation of the institution's critical information systems.
8. To ensure that operating procedures and controls are commensurate with the potential for and risks associated with security breaches, which may be either physical or electronic, inadvertent or intentional, or internal or external.
9. To determine the scope and adequacy of the IT audit function.
10. To evaluate IT outsourcing risk and outsourcing arrangements involving major lines of business.
11. To determine if the institution is complying with its written information security program and the minimum governing interagency standards on information security; the guidelines on the proper disposal of consumer information; and all applicable laws, rules, and regulations.
12. To find out if the financial institution (the bank and its respective operating subsidiaries) has developed, implemented, and maintained a written Identity Theft Prevention Program (Program) for its new and existing accounts that are covered by the Fair and Accurate Transactions Act of 2003 (FACT Act) and the Federal Reserve Board's rules on Fair Credit Reporting, section 222, Subpart J—Identity Theft Red Flags (12 CFR 222, Subpart J), which implements provisions of the FACT Act.
13. To make a determination of whether the financial institution's Program is
  - a. designed to detect, prevent, and mitigate identity theft in connection with the opening of a new, or an existing, covered account and that the Program includes the detection of relevant Red Flags;<sup>1</sup> and
  - b. appropriate to the size and complexity of the financial institution and the nature and scope of its activities.
14. To ascertain whether the financial institution assesses the validity of change of address notifications that it receives for the credit and debit cards that it has issued to customers.
15. To prepare comments for the report of examination on significant deficiencies and recommended corrective action.
16. To assign a Uniform Rating System for Information Technology (URSIT) rating or determine the impact of IT risks on the CAMELS or risk ratings.
17. To update the workpapers with any information that will facilitate future examinations.

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1. Red Flag means a pattern, practice, or specific activity that indicates the possible existence of identity theft.

1. Determine the role and importance of IT to the organization and whether any unique IT characteristics or issues exist. Identify and list or update the major automated banking applications. For those applications processed by outside service providers, indicate the name and location of each service provider.
2. Incorporate an analysis of IT activities into risk assessments, supervisory plans, and scope memoranda, considering the size, activities, and complexity of the organization, as well as the degree of reliance on these systems across particular business lines.
3. Assess the organization's critical IT systems—those that support its major business activities—and the degree of reliance those activities have on IT systems. (See the *FFIEC Information Systems Examination Handbook* for more information on reviewing the IT function.)
4. Determine if the systems are delivering the services necessary for the organization to conduct its business in a safe and sound manner.
5. Determine whether the board of directors and senior management are adequately identifying, measuring, monitoring, and controlling risks associated with IT for the overall organization and its major business activities.
6. Determine if the IT strategy for the significant business activities or the organization is consistent with the organization's mission and business objectives. Determine whether the IT function has effective management processes to execute that strategy.
7. Review the reliability, accuracy, and completeness of information delivered in key business lines.
8. Review the bank's information security program. Assess the adequacy of the organization's policies, procedures, and controls, as well as its compliance with them.
9. Determine the capability of backup systems, as presented in contingency plans, to mitigate business disruption.
10. Ascertain the quality and adequacy of the internal or external IT audit function or any independent application reviews to ensure the integrity, security, and availability of the organization's systems.
11. Complete or update the information technology internal control questionnaire (section 4060.4) for the specific applications identified in step 1 of these procedures, noting any of the following:
  - a. internal control exceptions and noncompliance with written policies, practices, and procedures
  - b. violations of law
  - c. exceptions to IT-servicing contracts
  - d. overall evaluation of services provided to the bank, including any problems experienced with the servicer
12. Complete or update the "Establishing Information Security Standards" portion of the internal control questionnaire. (See section 4060.4.) Examiners should use this information to assess an institution's compliance with the interagency information security standards and the guidelines for the proper disposal of consumer information. Depending on the nature of the institution's operations and the extent of prior supervisory review, all questions may not need to be answered fully. Other examination resources may also be used (for example, the *FFIEC Information Systems Examination Handbook*). Examiners should conduct a review that is a sufficient basis for evaluating the overall written information security program of the institution and its compliance with the interagency guidelines.
13. Verify that the financial institution has determined initially, and periodically thereafter, whether it offers or maintains accounts covered by the Fair and Accurate Transactions Act of 2003 (FACT Act) and section 222, Subpart J—Identity Theft Red Flags of the Board's rules on Fair Credit Reporting (12 CFR 222, Subpart J).
14. Determine if the financial institution has adequately developed and maintains a written Identity Theft Prevention Program (Program) that is designed to detect, prevent, and monitor transactions to mitigate identity theft in connection with the opening of certain new and existing accounts covered by the FACT Act.

15. Evaluate whether the Program includes reasonable policies and procedures to
  - a. identify and detect relevant Red Flags<sup>1</sup> for the financial institution's covered accounts and whether it incorporated those Red Flags into its Program;
  - b. respond appropriately to any detected Red Flags to prevent and mitigate identity theft; and
  - c. ensure that the program is updated periodically to reflect changes in identity theft risks to customers and the safety and soundness of the financial institution.
16. If a required Program has been established by the financial institution, ascertain if it has provided for the Program's continued administration, including
  - a. involving the board of directors, an appropriate committee thereof, or a designated employee at the level of senior management in the continued oversight, development, implementation, and administration of the Program;
  - b. training staff, as necessary, to effectively implement the Program; and
  - c. appropriate and effective oversight of service provider arrangements; and
17. If the financial institution has established and maintains a required Program that applies to its covered accounts, determine if the institution's Program includes the relevant and appropriate guidelines within the rule's appendix J (12 CFR 222, appendix J).
18. Determine whether the institution's controls over outsourcing information- and transaction-processing activities are adequate. Evaluate the adequacy of controls over outsourcing arrangements in the following areas:
  - a. outsourcing risk assessment
  - b. selection of service providers
  - c. contracts
  - d. policies, procedures, and controls
  - e. ongoing monitoring
  - f. information access
  - g. audit
  - h. contingency plan
19. Determine whether the bank has properly notified the Federal Reserve Bank of new outsourced services in accordance with the Bank Service Corporation Act (12 USC 1865).
20. Review any recent IT reports of examination on the institution's service providers performed by the Federal Reserve or other regulatory authorities, and note any deficiencies. Obtain a listing of any deficiencies noted in the latest audit review. Determine that all deficiencies have been properly corrected.
21. For banks with material in-house processing, use the Uniform Rating System for Information Technology (URSIT) rating system to help evaluate the entity's overall risk exposure and risk-management performance. Evaluate the areas identified within each relevant URSIT component to assess the institution's ability to identify, measure, monitor, and control IT risks.
22. Determine the extent of supervisory attention needed to ensure that IT weaknesses are addressed and that associated risk is properly managed. Determine the impact on CAMELS, the operational-risk rating, and any other risk ratings.
23. Prepare comments for the report of examination on any significant deficiencies and recommended corrective action.
24. Update the workpapers with any information that will facilitate future examinations.

<sup>1</sup> Red Flag means a pattern, practice, or specific activity that indicates the possible existence of identity theft.

# Information Technology

## Internal Control Questionnaire

Effective date October 2008

## Section 4060.4

Review the bank's internal controls, policies, practices, and procedures for information technology. The bank's system should be documented completely and concisely and should include, where appropriate, narrative description, flow charts, copies of forms used, and other pertinent information. Items below that are marked with an asterisk require substantiation by observation or testing.

### SERVICER SELECTION

1. Before entering into any service arrangement, did management consider—
  - a. alternative servicers and related costs?
  - b. the financial stability of the servicer?
  - c. the control environment at the data center?
  - d. emergency backup provisions?
  - e. the ability of the servicer to handle future processing requirements?
  - f. requirements for termination of service?
  - g. the quality of reports?
  - h. insurance requirements?
2. Is there an annual reevaluation of the servicer's performance that includes—
  - a. its financial condition?
  - b. costs?
  - c. its ability to meet future needs?
  - d. its quality of service?

### CONTRACTS

- \*1. Is each automated application covered by a written contract?
- \*2. Were contracts reviewed by legal counsel?
3. Does each service contract cover the following areas:
  - a. ownership and confidentiality of files and programs?
  - b. liability limits for errors and omissions?
  - c. frequency, content, and format of input and output?
  - d. the fee structure, including—
    - current fees?
    - provisions for changing fees?
    - fees for special requests?
  - e. provisions for backup and record protection?

### INSURANCE

- \*1. Does the serviced institution's insurance coverage include the following provisions:
  - a. extended blanket bond fidelity coverage to employees of the servicer?
  - b. insurance on documents in transit, including the cash letter?
  - c. if the serviced institution is relying on the servicer or an independent courier for the insurance described above, is adequate evidence of that coverage on file?

### OPERATIONAL CONTROLS

- \*1. Are duties adequately separated for the following functions:
  - a. input preparation?
  - b. operation of data-entry equipment?
  - c. preparation of rejects and unposted items for reentry?
  - d. reconciliation of output to input?
  - e. output distribution?
  - f. reconciliation of output to general ledger?
  - g. posting general ledger?
2. Are employee duties periodically rotated for control and training purposes?
3. Do supervisors or officers—
  - a. adequately review exception reports?
  - b. approve adjusting entries?

4. Are servicer personnel prohibited from initiating transactions or correcting data?
  5. Are individuals prohibited from initiating or authorizing a transaction and then executing it?
  6. Are employees at the serviced institution required to be absent from their duties (by vacation or job rotation) for two consecutive weeks?
  7. Are master-file changes—
    - a. requested in writing?
    - b. approved by a supervisor?
    - c. verified as correct after processing?
  - \*8. Are exception reports prepared for—
    - a. unposted and rejected items?
    - b. supervisory-override transactions?
    - c. master-file changes (before and after)?
    - d. dormant-account activity?
  - \*9. Does each user department—
    - a. establish dollar and nondollar control totals before they are sent for processing?
    - b. receive all scheduled output reports even when the reports contain no activity?
    - c. review all output and exception reports?
  - \*10. Are current user manuals available for each application, and do employees use them?
  11. Does each user manual cover—
    - a. preparation and control of source documents?
    - b. control, format, and use of output?
    - c. settlement and reconciliation procedures?
    - d. error-correction procedures?
  12. Are users satisfied with the servicer's performance and output reports? (If not, explain.)
  13. Are computer-generated entries subsequently reviewed and approved by appropriate officials?
  - \*14. Does the serviced institution copy all source documents, including cash letters, on microfilm before they leave the premises? If so—
    - a. is the microfilm stored in a secure location with limited access?
    - b. is an inventory and usage log maintained?
- b. physical keys?
  - c. passwords?
  - d. other safeguards (explain)?
  2. Are periodic changes made to numbers, keys, or passwords, and are they adequately controlled?
  3. Are identification numbers or passwords suppressed on all printed output and video displays?
  4. Are terminals controlled as to—
    - a. what files can be accessed?
    - b. what transactions can be initiated?
    - c. specific hours of operations?
  5. Do controls over restricted transactions and overrides include—
    - a. supervisory approval?
    - b. periodic management review?
  - \*6. Are there exception reports that indicate—
    - a. all transactions made at a terminal?
    - b. all transactions made by an operator?
    - c. restricted transactions?
    - d. correcting and reversing entries?
    - e. dates and times of transactions?
    - f. unsuccessful attempts to gain access to the system or to restricted information?
    - g. unusual activity?
  7. Overall, are there adequate procedures in effect that prevent unauthorized use of the data communication systems?
  8. To back up online systems—
    - a. are offline capabilities available (explain)?
    - b. are the offline capabilities periodically tested?

## AUDITING

1. Is there an internal auditor or member of management not directly involved in EDP activities who has been assigned responsibility for the audit function?
2. Does that individual have any specialized audit or EDP training?
3. Are there written internal audit standards and procedures that require—
  - a. review of all automated applications?
  - b. reports to the board of directors?
  - c. audit workpapers?
4. Does the person responsible for the

## COMMUNICATION CONTROLS

- \*1. Is user access to the data communication network controlled by—
  - a. user number?

- audit function perform the following procedures:
- a. test the balancing procedures of all automated applications, including the disposition of rejected and unposted items?
  - b. periodically sample master-file information to verify it against source documents?
  - c. spot-check computer calculations, such as interest on deposits, loans, securities, loan rebates, service charges, and past-due loans?
  - d. verify output report totals?
  - e. check accuracy of exception reports?
  - f. review master-file changes for accuracy and authorization?
  - g. trace transactions to final disposition to determine the adequacy of audit trails?
  - h. review controls over program-change requests?
  - i. perform customer confirmations?
  - j. other (explain)?
5. Does the serviced institution obtain and review the servicer's internal or external audits or third-party reviews? (If yes, detail exceptions and corrective action.)
  6. Has the serviced institution used an independent auditor to evaluate EDP servicing (if yes, detail exceptions and corrective action)?
  7. Is the overall audit program for serviced applications considered adequate?
3. Does the bank periodically update its information security program to reflect changes in the bank's operations and systems, as well as changes in threats or risks to the bank's customer information?
  4. Does the examination review of the bank's process for assessing risk to its customer information address the following questions:
    - a. Has the bank identified the locations, systems, and methods for storing, processing, transmitting, and disposing of its customer information?
    - b. Has the bank identified reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems, and has the bank assessed the likelihood of these threats and their potential damage to the bank and its customers?
  5. With respect to the bank's risk-management processes for implementing effective measures to protect customer information, does the bank adopt and review appropriate risk-based internal controls and procedures for the following:
    - a. accessing controls on computer systems containing customer information in order to prevent access by unauthorized staff or other individuals?
    - b. preventing employees from providing customer information to unauthorized individuals, including "pretext calling," that is, someone calling a bank and posing as a customer to fraudulently obtain an individual's personal information? (See SR-01-11.)
    - c. providing access restrictions at physical locations containing customer information, such as buildings, computer facilities, and records-storage facilities, in order to permit access to authorized individuals only?
    - d. encrypting electronic customer information, including information that is in transit or in storage on networks or systems, when unauthorized individuals are able to gain access to it?
    - e. ensuring that modifications to customer information systems are consistent with the bank's information security program?

## ESTABLISHMENT OF INFORMATION SECURITY STANDARDS

1. Does the bank have a written information security program or policy that complies with the Interagency Guidelines Establishing Information Security Standards, in Regulation H, appendix D-2 (12 CFR 208, appendix D-2)? Has the board of directors or an appropriate designated committee of the board approved the written information security program?
2. Is the written information security program appropriate given the size and complexity of the organization and its operations? Does the program contain the objectives of the program, assign responsibility for implementation, and provide



- f. maintaining dual-control procedures, segregation of duties, and background checks for employees with access to customer information to minimize the risk of internal misuse of customer information?
  - g. monitoring systems and procedures to detect unauthorized access to customer information systems that could compromise the security of customer information?
  - h. maintaining and complying with the minimum requirements for response programs that specify actions to be taken when the bank suspects or detects that unauthorized individuals have gained access to customer information systems? (These programs include appropriate reports, such as Suspicious Activity Reports by Depository Institutions (SAR-DI), disseminated to regulatory and law enforcement agencies.) See SR-07-2 and the attached June 2007 SAR-DI form, the requirements for suspicious-activity reporting in section 208.62 of the Board's Regulation H (12 CFR 208.62), and the Bank Secrecy Act compliance program in section 208.63 (12 CFR 208.63).
  - i. providing measures to protect against destruction, loss, or damage of customer information due to potential environmental hazards, such as fire and water damage or technological failures?
  - j. providing measures to ensure the proper disposal of consumer information derived from consumer reports?
6. Have the bank's employees been trained to implement the information security program?
  7. Does the bank regularly test the effectiveness of the key controls, systems, and procedures of its information security program? These tests may include, for example, tests of operational contingency plans, system security audits or "penetration" tests, and tests of critical internal controls over customer information. Are tests conducted and reviewed independently by the bank's designated staff?
  8. Does the bank provide customer information to any service providers, or do any service providers have access to customer information as a result of providing services directly to the bank? If so—
    - a. has the bank conducted appropriate due diligence in selecting its service providers, taking into consideration information security?
    - b. do the bank's contracts with its service providers require implementation of appropriate information security programs and measures?
    - c. where appropriate and based on risk, does the bank monitor its service providers to confirm that they are maintaining appropriate security measures to safeguard the bank's customer information? Does the bank, for example, conduct or review the results of audits, security reviews or tests, or other evaluations?
  9. Does the bank's management report at least annually to the board of directors, or to a designated appropriate board committee, on the overall status of the information security program and the extent of the bank's compliance with the standards and guidelines?

## IDENTITY THEFT RED FLAGS

1. Did the bank (financial institution) determine initially, and has it periodically determined, whether it offers or maintains accounts covered by the Fair and Accurate Transactions Act of 2003 (FACT Act) and section 222, Subpart J—Identity Theft Red Flags of the Board's rules on Fair Credit Reporting (12 CFR 222, Subpart J)?
2. Has the financial institution adequately developed and maintained a written Identity Theft Prevention Program (Program) that is designed to detect, prevent, and mitigate identity theft in connection with the opening of new and existing accounts that are covered by the FACT Act?
3. Did the financial institution evaluate whether its Program includes reasonable policies and procedures to
  - a. identify relevant Red Flags<sup>1</sup> for the financial institution's covered accounts and has it incorporated those Red Flags into its Program;

1. Red Flag means a pattern, practice, or specific activity that indicates the possible existence of identity theft.

- b. respond appropriately to prevent and mitigate identity theft detected by any Red Flags; and
  - c. ensure that the Program is updated periodically to reflect changes in identity theft risks to customers and to the safety and soundness of the financial institution?
4. Has the Program included Red Flags from sources such as
- a. incidents that the financial institution has experienced;
  - b. methods of identity theft that the financial institution has identified that reflects changes in identity theft risks; and
  - c. applicable supervisory guidance?
5. Does the Program include relevant Red Flags from the following categories (see supplement A to appendix J):
- a. alerts, notifications, or other warnings received from consumer reporting agencies or service providers, such as a fraud detection services;
  - b. the presentation of suspicious documents;
  - c. the presentation of suspicious personal identifying information, such as a suspicious address change;
  - d. the unusual use of, or other suspicious activity related to, a covered account; and
  - e. notice from customers, victims of identity theft, law enforcement authorities, or other persons regarding possible identity theft in connection with covered accounts held by the financial institution or creditor?
6. If the financial institution has established and maintained a required Program, has the institution's Program included the relevant and appropriate guidelines that are found in the Board's rule's appendix J (12 CFR 222, appendix J)?
7. Were the examples of factors in appendix J's guidelines considered initially, and periodically, to determine the relevancy and appropriateness of the Program's Red Flags, such as
- a. the types of accounts it offers or maintains;
  - b. the methods it provides to open its covered accounts;
  - c. the methods it provides to access its covered accounts;
  - d. its previous experiences with identity theft; and
  - e. changes in the financial institution's business arrangements, including its mergers, acquisitions, and joint ventures, and its alliances and service provider arrangements?
8. Does the Program's policies and procedures address the detection of Red Flags in connection with the financial institution's opening of covered accounts and existing covered accounts such as by
- a. obtaining identifying information about, and verifying the identity of, a person opening a covered account; and
  - b. authenticating customers, monitoring transactions; and verifying the validity of change of address requests?
9. If a required Program has been established by the financial institution, has it provided for the Program's continued administration by
- a. involving the board of directors, an appropriate committee thereof, or a designated employee at the level of senior management in the continued oversight, development, implementation, and administration of the Program?
  - b. training staff, as necessary, to effectively implement the Program?
  - c. providing appropriate and effective oversight of its service provider arrangements?

## CONCLUSION

1. Does the foregoing information constitute an adequate basis for evaluating internal control (that is, no significant deficiencies in areas not covered in this questionnaire impair any controls)? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
2. On the basis of a composite evaluation, as evidenced by answers to the foregoing questions, is internal control considered adequate or inadequate?



Electronic and Internet banking products and services have been widely adopted by financial institutions and are now a regular component of the business strategies at most institutions. Electronic and Internet delivery of services can have many far-reaching benefits for financial institutions and their customers. In some cases, however, these activities can have implications for a financial institution's financial condition, risk profile, and operating performance.

### EXAMINATION APPROACH

In general, examiners should review electronic and Internet banking activities when these services are newly implemented, particularly in institutions that may not have significant experience or expertise in this area or when an institution is conducting novel activities that may pose a heightened risk. Periodic reviews should be conducted thereafter based on any significant changes to the scope of services or nature of the operations, as indicated by an assessment of risk to the institution.

Clearly, electronic and Internet banking concerns could affect an institution's operational-risk profile. Yet, these activities could also affect other financial and business risks, depending on the specific circumstances. Accordingly, examiners should consider an institution's electronic and Internet banking activities when developing risk assessments and supervisory plans. Although electronic and Internet banking may be assessed within the context of an information technology review, the nontechnical aspects of an electronic banking operation should be reviewed and coordinated closely with other examination areas. Rather than conduct detailed technical reviews, examiners should assess the overall level of risk any electronic and Internet banking activities pose to the institution and the adequacy of its approach to managing these risks.

To determine the scope of supervisory activities, close coordination is needed with information technology specialist examiners and consumer compliance examiners during the risk-assessment and planning phase, as well as during on-site examinations. Given the variability of electronic and Internet banking environments, the level of technical expertise required for a particular examination will differ across

institutions and should be identified during the planning phase of the examination. When the bank has developed the electronic and Internet banking products or services internally or when a direct connection exists between the institution's electronic and Internet banking systems and its core data processing system, consideration should be given to involving an information technology specialist examiner in the on-site review. The determination of the examination scope should be based on factors such as the following:

- implementation of significant new electronic banking products and services since the last examination
- significant changes in the composition or level of customers, earnings, assets, or liabilities generated or affected by the electronic banking activities
- new or significantly modified systems or outsourcing relationships for activities related to electronic banking
- the need for targeted examinations of business lines that rely heavily on the electronic banking systems or activities
- other potential problems or concerns that may have arisen since the last examination or the need to follow up on previous examination or audit issues

Many resources are available to examiners for reviewing electronic and Internet banking activities. In addition to the procedures in this section, further information can be found in section 4060.1, "Information Technology," and in the *Federal Financial Institutions Examination Council (FFIEC) Information Systems Examination Handbook*. Other federal banking agencies have issued examination guidance relating to electronic and Internet banking, information technology, and information security that may be helpful to examiners in reviewing electronic banking activities. Consumer compliance issues are not addressed in this section.<sup>1</sup>

1. See the Federal Reserve regulations, FFIEC, and other interagency supervisory guidance. See also the FFIEC's "Guidance on Electronic Financial Services and Consumer Compliance" (July 15, 1998), for further information regarding compliance with consumer laws and regulations.

## OVERVIEW OF ELECTRONIC BANKING SERVICES

### Types of Services

Electronic banking services (including Internet banking services) are designed to provide banking customers with the capability to conduct banking business remotely through personal computers and other electronic devices. Electronic banking comprises personal computer (PC) banking through traditional proprietary communication channels; retail and corporate Internet banking services; telephone banking; and, potentially, other forms of remote electronic access to banking services.

Both large and small institutions offer a variety of Internet-based financial services. Many financial institutions are using the Internet to enhance their service offerings to existing customers. Other organizations may choose to expand their customer base to a wider geographic area by accepting online applications for loan and deposit products. A very small number of banking organizations are focusing on the Internet as their primary delivery channel, whether or not they maintain physical branches.

Current electronic banking products and services typically allow customers to obtain information on bank products and services through the bank's Internet web sites, apply online for new products and services, view loan- and deposit-account balances and transactions, transfer funds between accounts, and perform other banking functions. Most electronic banking services operate using standard Internet browser software installed on the customer's personal computer and do not require that the customer have any additional software or hardware. While electronic banking services have been oriented toward retail customers, many banking organizations offer small-business applications and corporate cash-management services through the Internet. These services typically include payroll, automated clearinghouse (ACH), and wire transfers. Wholesale banking services, which have been conducted electronically for many years, are also beginning to move from proprietary networks and communications channels to the Internet.

Information-only web sites provide the most basic and common form of electronic banking service. Most institutions contract with an Inter-

net service provider (ISP) to provide Internet access and "host," or maintain and operate, the institution's web site. In some cases, the web site is maintained on the institution's own computers (web servers). Even if access to account information is not possible through the web site, institutions may receive e-mail inquiries from customers through their web site.

Transactional Internet banking sites allow customers to obtain online access to their account information and initiate transactions over the Internet. With most Internet banking services, the customer interacts with a stand-alone Internet banking system that has been preloaded with the customer's account balances, transaction history, and other information. Transactions initiated through the Internet banking system are processed by a separate Internet banking application and periodically posted to the institution's general ledger, deposit, and loan accounting systems. Interface or connection with the financial institution's core data processing and accounting systems typically occurs through either (1) a direct connection to the core processing system over a network or (2) a manual download or transfer of transaction data to a diskette or other portable media, which is then uploaded or sent to the core processing system. Most standardized Internet banking software packages now available have been designed with standard interfaces between Internet banking systems and common core-processing systems and software.

Electronic bill-payment services are typically provided to customers as part of most standard electronic banking services. These services generally include capabilities to pay any third party the customer designates, as well as pay companies designated for routine bill payments, such as utilities and credit card issuers. Electronic bill-presentment services, which are much less common, involve the electronic transmission of billing statements to the customer through e-mail or a web site, for subsequent payment through the electronic banking service.

Telephone banking, a fairly conventional form of electronic banking, is provided by many institutions. Telephone banking services generally allow customers to check account balances and transactions and to pay bills through touch-tone or voice-response systems. Banking organizations also offer consumer products and services through wireless devices, such as cellular telephones, pagers, personal digital assistants, handheld computers, or other devices that can

provide wireless access to an institution's services, either directly or through the Internet. Account aggregation is a web-based service offered by some financial institutions that consolidates customer-account information from multiple financial or commercial web sites and presents it on a single web site. Aggregated information may include information from financial and nonfinancial accounts held by the customer. Some institutions have established "portals," web sites that link customers to a variety of third-party sites, and alliances with other companies to provide banking or nonbanking services.

## Operations

There are a variety of operational methods for providing electronic banking services. Banking organizations may perform their core data processing internally but outsource the Internet banking activities to a different vendor or service provider. A dedicated workstation at the financial institution is often used to transmit transaction data files between the institution's core processing system and the Internet application; the workstation also allows the financial institution to update parameters and perform other maintenance. Alternatively, the service provider for Internet banking may interface directly with the bank's core-processing service provider, if that function is also outsourced. In addition, many banking organizations purchase Internet banking services from their primary core-processing service provider, eliminating the need for external data transmissions. Even with this last structure, the institution maintains a local workstation to provide access to customer information or perform other administrative and maintenance functions for the Internet banking system.

Other institutions operate an electronic banking system in their own computer facilities by purchasing an "off-the-shelf" or turnkey electronic banking software application from a software vendor and then installing the software on their own system. Turnkey options vary from a bank's purchase and use of templates or modules, in which the bank chooses from a selection of standard services, to more complex situations in which the software vendor designs and develops the electronic banking software application to the bank's specifications. Turnkey vendors

often provide hardware, software, and ongoing system service and maintenance.

Bill-payment processing is generally conducted through a specialized third-party processor. The payment processor receives payment instructions from the financial institution or the Internet banking service provider, initiates an ACH debit to the account of the customer, and credits the account of the payee. Payments to payees not set up to receive ACH payments, such as individuals and smaller companies, are transmitted by mailing a paper check to the payee.

## RISK MANAGEMENT

### Board and Management Oversight

Financial institutions commonly implement electronic banking services as a means of delivering existing banking products and services to existing customers. As a result, not all institutions have established a distinct risk-management program for electronic banking. In many cases, policies and procedures for electronic banking activities will be incorporated into existing policies and procedures, such as those governing deposit accounts, payments processing, information security, and lending functions.

Bank management should assess the financial impact of the implementation and ongoing maintenance of electronic banking services. For example, ongoing maintenance and marketing costs of Internet banking operations can be substantial, particularly for smaller banks, depending on the institution's business plan. Bank management should consider the potential impact on the institution's customer base, loan quality and composition, deposit volume, volatility, liquidity sources, and transaction volume, as well as the impact on other relevant factors that may be affected by the adoption of new delivery channels. These areas should be monitored and analyzed on an ongoing basis to ensure that any impact on the institution's financial condition resulting from electronic banking services is appropriately managed and controlled.

In addition, bank management may wish to review periodic reports tracking customer usage, problems such as complaints and downtime, unreconciled accounts or transactions initiated through the electronic banking system, and system usage relative to capacity. Management

should also consider the expertise of internal or external auditors to review electronic banking activities and the inclusion of electronic banking activities within audit plans. Insurance policies may need to be updated or expanded to cover losses due to system security breaches, system downtime, or other risks from electronic banking activities.<sup>2</sup>

A change in an institution's business strategy to an Internet-only or Internet-focused operation is generally considered a significant change in business plan.<sup>3</sup> In addition, certain technology operations, such as providing ISP services to the general public, may not be considered permissible banking activities or may be considered permissible by the institution's chartering authority only within certain limitations.

A financial institution should also consider legal ownership of its Internet address (for example, www.bankname.com), also known as its "domain name." Contracts with third-party vendors may specifically address any arrangements to have the third-party vendor register the domain name on behalf of the institution.

## Operational and Internal Controls

### *Web Site Information Maintenance*

Because an institution's web site is available on an ongoing basis to the general public, appropriate procedures should be established to ensure the accuracy and appropriateness of its information. Key information changes and updates, such as loan rates, are normally subject to documented authorization and dual verification. Establishing procedures and controls to frequently monitor and verify web site information may help prevent any inadvertent or unauthorized modifications or content, which could lead to reputational damage or violations of advertis-

2. See section 4040.1, "Management of Insurable Risks," for further information about fraud and computer-related insurance that may be applicable to electronic banking activities.

3. Regulation H sets forth the requirements for membership of state-chartered banks in the Federal Reserve System and imposes certain conditions of membership on applicant banks. A member bank must "at all times conduct its business and exercise its powers with due regard to safety and soundness" and "may not, without the permission of the Board, cause or permit any change in the general character of its business or in the scope of the corporate powers it exercises at the time of admission to membership" (12 CFR 208.3(d)(1) and (2)).

ing, disclosure, or other compliance requirements.

In addition, some institutions provide financial-calculator, financial-management, tax-preparation, and other interactive programs to customers. Institutions may provide online resources for customers to research available options associated with savings products, mortgages, investments, insurance, or other products and services. To protect the institution from potential liability or reputational harm, the bank should test or otherwise verify the accuracy and appropriateness of these tools.

Banks should carefully consider how links to third-party Internet web sites are presented. Hyperlinks to other web pages provide customers with convenient access to related or local information, as well as provide a means for targeted cross-marketing through agreements between the institution and other web site operators. However, such linkages may imply an endorsement of third-party products, services, or information that could lead to implicit liability for the institution. As a result, institutions commonly provide disclaimers when such links take the customer to a third-party web site. Institutions should ensure that they clearly understand any potential liabilities arising out of any cross-marketing arrangements or other agreements with third parties. Any links to sites offering nondeposit investment or insurance products must comply with relevant interagency guidelines.<sup>4</sup> Links to other sites should be verified regularly for their accuracy, functionality, and appropriateness.

### *Customer Authentication in an Electronic Banking Environment and Administrative Controls*

#### *Customer authentication guidance issuances.*

The federal banking agencies have issued various iterations of examination guidance on authentication in an Internet banking environment to assist examiners with this evolving issue. On August 8, 2001, the FFIEC initially released "Authentication in an Electronic Banking Environment," which reviewed the risks and risk-management controls of authentication tools used to verify the identity of new cus-

4. See section 4170.3, "Examination Procedures—Retail Sales of Nondeposit Investment Products," and the consumer protection rules for sales of insurance (65 Fed. Reg. 75,822 (December 4, 2000)).

tomers and authenticate existing customers. In response to significant legal and technological changes, the FFIEC issued a similarly titled statement on October 12, 2005, which replaced the 2001 guidance. As discussed in this section, the 2005 guidance addressed the need for risk-based assessments, customer awareness, and enhanced security measures to authenticate customers using Internet-based products and services that process high-risk transactions involving access to customer information or the movement of funds to other parties. One of the key points of emphasis of the guidance was that single-factor authentication, as the only control mechanism, is inadequate for high-risk transactions involving access to customer information or the movement of funds to other parties. (See SR-05-19.) To assist the banking industry and examiners, the Board, the FFIEC, and the other federal banking and thrift agencies issued frequently asked questions (FAQs) on August 15, 2006. (See SR-06-13.) The FAQs are designed to assist the financial institutions and their technology service providers in conforming to the guidance by addressing common questions on the scope, risk assessments, timing, and other issues.

On June 29, 2011, the FFIEC released “Supplement to Authentication in an Internet Banking Environment.” (See SR-11-9.) The purpose of the 2011 supplement is to reinforce the existing guidance on risk-management framework and update the agencies’ expectations regarding customer authentication, layered security, or other controls in the increasingly hostile online environment. The supplement establishes minimum control expectations for certain online banking activities and identifies controls that are less effective in certain situations.

*Customer authentication background.* Authentication describes the process of verifying the identity of a person or entity. The authentication process is one method used to control access to customer accounts and personal information, and is dependent upon customers providing valid identification data followed by one or more authentication credentials (factors) to prove their identity. Many banks use the same account-opening procedures for electronic applications as they do for mailed or in-person applications. Procedures for accepting electronic account applications generally address areas such as—

- the type of funding accepted for initial deposits;
- funds-availability policies for deposits in new accounts;
- the timing of account-number, check, and ATM-card issuance;
- the minimum customer information required to open new accounts;
- single-factor, tiered single-factor, and multi-factor authentication procedures for verification of information provided by the applicant (for example, verifying customer information against credit bureau reports); and
- screening for prior fraudulent account activity, typically using fraud-detection databases.<sup>5</sup>

Strong customer-authentication practices are necessary to help institutions detect and reduce fraud, detect and reduce identity theft, and enforce anti-money-laundering measures. Customer interaction with institutions continues to migrate from physical recognition and paper-based documentation to remote electronic access and transaction initiation. Significant risks potentially arise when an institution accepts new customers through the Internet or other purely electronic channels because of the absence of the physical cues that bankers traditionally use to identify individuals. The risks of doing business with unauthorized or incorrectly identified individuals in an electronic banking environment could result in financial loss and reputation damage.

In addition to limiting unauthorized access, effective authentication provides institutions with the appropriate foundation for electronic agreements and transactions. First, effective authentication provides the basis for the validation of parties to the transaction and their agreement to its terms. Second, authentication is a necessary element to establish the *authenticity* of the records evidencing the electronic transaction if there is ever a dispute. Third, authentication is a necessary element for establishing the *integrity* of the records evidencing the electronic transaction. Because state laws vary, management should involve legal counsel in the design and implementation of authentication systems.

The success of a particular authentication method depends on more than the technology.

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5. For information on practices that may help prevent fraudulent account activity, see SR-01-11, “Identity Theft and Pretext Calling.”

Success also depends on an institution's having appropriate policies, procedures, and controls. An effective authentication method has the following characteristics: customer acceptance, reliable performance, scalability to accommodate growth, and interoperability with existing systems and future plans. The June 29, 2011, "Supplement to Authentication in an Internet Banking Environment" discusses the effectiveness of certain authentication techniques, namely device identification and the use of challenge questions.

Institutions can use a variety of authentication tools and methodologies to authenticate customers. These tools include the use of passwords and personal identification numbers (PINs), digital certificates using a public key infrastructure (PKI), physical devices such as smart cards or other types of "tokens," database comparisons, and biometric identifiers. The level of risk protection afforded by each of these tools varies and is evolving as technology changes.

Existing authentication methodologies involve three basic "factors":

- something the user *knows* (a password or PIN)
- something the user *possesses* (an ATM card or a smart card)
- something the user *is* (a biometric characteristic, such as a fingerprint or retinal pattern)

Authentication methods that depend on more than one factor typically are more difficult to compromise than single-factor systems. Accordingly, properly designed and implemented multifactor authentication methods are more reliable indicators of authentication and are stronger fraud deterrents. For example, the use of a log-on ID or password is single-factor authentication (something the user knows), whereas a transaction using an ATM typically requires two-factor authentication (something the user possesses—the card—combined with something the user knows—the PIN). In general, multifactor authentication methods should be used on higher-risk systems. Further, institutions should be sensitive to the fact that proper implementation is key to the reliability and security of any authentication system. For example, a poorly implemented two-factor system may be less secure than a properly implemented single-factor system.

*Risk assessment.* An effective authentication program should be implemented on an enterprise-

wide basis to ensure that controls and authentication tools are adequate among all products, services, and lines of business. Authentication processes should be designed to maximize interoperability and should be consistent with the financial institution's overall strategy for electronic banking and e-commerce customer services. The level of authentication a financial institution uses in a particular application should be appropriate to the level of risk in that application.

The implementation of appropriate authentication methods starts with an assessment of the risk posed by the institution's electronic banking systems. The risk-assessment process should

- identify all transactions and levels of access associated with Internet-based customer products and services;
- identify and assess the risk-mitigation techniques, including authentication methodologies, employed for each transaction type and level of access; and
- include the ability to gauge the effectiveness of risk-mitigation techniques for current and changing risk factors for each transaction type and level of access.

The risk should be evaluated in light of the type of customer (retail or commercial), the institution's transactional capabilities (bill payment, wire transfer, or loan origination), the sensitivity and value of the stored information to both the institution and the customer, the ease of using the authentication method, and the size and volume of transactions.

For example, online retail transactions generally involve accessing account information, bill payment, intrabank funds transfers, and occasional interbank funds transfers or wire transfers. Since the frequency and dollar amounts of these transactions are generally lower than commercial transactions, they pose a comparatively lower level of risk. Online commercial transactions generally involve ACH file origination and frequent interbank wire transfers. Since the frequency and dollar amounts of these transactions are generally higher than consumer transactions, they pose a comparatively increased level of risk to the institution and its customer. As such, it is recommended that institutions offer multifactor authentication to their business customers.

The Federal Reserve expects financial institutions to assess the risks to the institution and



its customers and to implement appropriate authentication methods to effectively manage risk. Financial institutions should review and update their existing risk assessments as new information becomes available, prior to implementing new electronic financial services, or at least every 12 months. (See *FFIEC IT Examination Handbook*, Information Security Booklet, July 2006, Key Risk Assessment Practices section.) Updated risk assessments should consider, but not be limited to, the following factors:

- changes in the internal and external threat environment (see the attachment to SR 11-9 for more information)
- changes in the customer base adopting electronic banking
- changes in the customer functionality offered through electronic banking
- actual incidents of security breaches, identity theft, or fraud experienced by the institution or industry

A comprehensive approach to authentication requires development of and adherence to corporate standards and architecture, integration of authentication processes within the overall information security framework, risk assessments within the institution's lines of business that support the selection of authentication tools, and a central authority for oversight and risk monitoring. The authentication process should be consistent and support the financial institution's overall security and risk-management programs.

The methods of authentication used in a specific electronic application should be appropriate and "reasonable," from a business perspective, in light of the reasonably foreseeable risks in that application. Because the standards for implementing a commercially reasonable system may change over time as technology and other procedures develop, financial institutions and service providers should periodically review authentication technology and ensure appropriate changes are implemented.

Single-factor authentication tools, including passwords and PINs, have been widely utilized in a variety of retail e-banking activities, including account inquiry, bill payment, and account aggregation. However, not every online transaction poses the same level of risk. Therefore, financial institutions should implement more robust controls as the risk level of the transaction increases. Financial institutions should assess the adequacy of existing authentication

techniques in light of changing or new risks (for example, the increasing ability of hackers to compromise less robust single-factor techniques or the risks posed by phishing, pharming, or malware). Financial institutions should no longer rely on one form of customer authentication. A one-dimensional customer authentication program is simply not robust enough to provide the level of security that customers expect and that protects institutions from financial and reputational risk. Instead, multifactor techniques are appropriate for high-risk applications and transactions, which involve access to customer information or the movement of funds to other parties. Institutions should recognize that a single-factor system may be "tiered" to enhance security without implementing a two-factor system. A tiered single-factor authentication system would include the use of multiple levels of a single factor (for example, the use of two or more passwords or PINs employed at different points in the authentication process).

*Account origination and customer verification.* Institutions need to use reliable methods for originating new customer accounts online. Customer-identity verification during account origination is important in reducing the risk of identity theft, fraudulent account applications, and unenforceable account agreements or transactions. In an electronic banking environment, reliance on traditional forms of paper-based authentication is decreased substantially. Accordingly, financial institutions need to use reliable alternative methods. For example, verification of personal information could include the following:

- *Positive verification* to ensure that material information provided by an applicant matches information available from trusted third-party sources. More specifically, an institution can verify a potential customer's identity by comparing the applicant's answers to a series of detailed questions against information in a trusted database (for example, a reliable credit report) to see if the information supplied by the applicant matches information in the database. As the questions become more specific and detailed, correct answers provide the institution with an increasing level of confidence that the applicants are who they say they are.
- *Logical verification* to ensure that information provided is logically consistent. (For example,

do the telephone area code, ZIP code, and street address match?)

- *Negative verification* to ensure that information provided has not previously been associated with fraudulent activity. For example, applicant information can be compared against fraud databases to determine whether any of the information is associated with known incidents of fraudulent behavior. In the case of commercial customers, however, a sole reliance on online electronic database comparison techniques is not adequate since certain documents needed to establish an individual's right to act on a company's behalf (for example, bylaws) are not available from databases. Institutions must still rely on traditional forms of personal identification and document validation combined with electronic verification tools.

*Transaction initiation and authentication of established customers.* Once an institution has successfully verified a customer's identity during the account-origination process, it should authenticate customers who wish to gain access to the online banking system. Institutions can use a variety of methods to authenticate existing customers. These methods include the use of passwords, PINs, digital certificates and a PKI, physical devices such as tokens, and biometrics.

*Minimizing fraud risk.* An institution's policies and procedures should address the management of existing customers' accounts to minimize the risk of fraudulent activity. For example, the customer's ability to expand an existing account relationship through the electronic banking system may warrant added controls, such as sending a separate notification to a customer's physical address when online account access is first requested or when PINs, e-mail addresses, or other key parameters are changed.

To mitigate fraud risk, institutions may establish dollar limits on transactions initiated through the electronic banking application, or they may monitor transactions above specified limits, depending on the type of account (for example, consumer versus corporate). These limits or a similar monitoring system may help detect unusual account activity, which could indicate fraudulent transactions or other suspicious activity.

*Funds transfer systems and Internet banking.* Any manual interface between the electronic

banking system and funds transfer systems, such as capabilities for uploading ACH or Fedwire transactions initiated through the electronic banking system to Fedline terminals, should be subject to system-access controls and appropriate internal controls, such as segregation of duties. Some institutions also permit electronic banking customers to initiate electronic (ACH) debits against accounts held at other institutions; reliable controls to verify that the customer is entitled to draw funds from the particular account are needed if this feature is offered.

Electronic bill-payment services are commonly provided as a component of electronic banking services. The institution should have a direct agreement with bill-payment providers, which may be subcontractors of the provider for the institution's Internet banking services. In this situation, it may be difficult for the institution or its customers to obtain timely and accurate information regarding the status of payment requests. As a result, contracts with service providers that encompass bill-payment services should generally address how payments are made, when payments are debited from a customer account, the treatment of payments when the account has insufficient funds on the settlement date, reconciliation procedures, and problem-resolution procedures.

Even when Internet banking operations are outsourced to a service provider, institutions will generally have access to the electronic banking system through a dedicated desktop computer or workstation. This hardware allows the institution to upload and download transaction information; review transaction logs or audit trails; print daily reports; or, in some cases, reset customer passwords, resolve errors, or respond to customer inquiries. These workstations should be located in secure areas and be subject to normal authorization and access controls and transaction audit trails.

## Information Security

Electronic banking activities should be addressed in an institution's information security program, which should include compliance with the federal banking agencies' information security standards.<sup>6</sup> Institutions

6. See section 4060.1 under "Standards for Safeguarding Customer Information" for further details and examination procedures. See also SR-01-25. See also the *FFIEC IT*



need to pay particular attention to the security of customer information, given the heightened security concerns associated with providing access to customer information over the Internet. An institution's written information security policies and procedures should include electronic banking activities. Institutions should implement prudent controls that limit the risk of unauthorized access to key systems, including password-administration controls, firewalls, encryption of sensitive information while it is in transit or being stored, maintenance of all current updates and security patches to software and operating systems, and controls to prevent insider misuse of information. Sound information security practices include procedures and systems to detect changes to software or files, intrusion-detection systems, and security-vulnerability assessments.

Sound information security practices are also based on the concept of layered security, which is the use of different controls at different points in a transaction process so that a weakness in one control is generally compensated for by the strength of a different control. Layered security can substantially strengthen the overall security of Internet-based services and be effective in protecting sensitive customer information, preventing identity theft, and reducing account takeovers and the resulting financial losses. Financial institutions should implement a layered approach to security for high-risk Internet-based systems. Other regulations and guidelines also specifically address financial institutions' responsibilities to protect customer information and prevent identity theft.<sup>7</sup>

Effective controls that may be included in a layered security program include, but are not limited to

- fraud detection and monitoring systems that include consideration of customer history and behavior and enable a timely and effective institution response;
- the use of dual customer authorization through different access devices;

- the use of out-of-band verification for transactions;
- the use of "positive pay," debit blocks, and other techniques to appropriately limit the transactional use of the account;
- enhanced controls over account activities, such as transaction value thresholds, payment recipients, number of transactions allowed per day, and allowable payment windows (e.g., days and times);
- Internet protocol (IP) reputation-based tools to block connection to banking servers from IP addresses known or suspected to be associated with fraudulent activities;
- policies and practices for addressing customer devices identified as potentially compromised and customers who may be facilitating fraud;
- enhanced control over changes to account maintenance activities performed by customers either online or through customer service channels; and
- enhanced customer education to increase awareness of the fraud risk and effective techniques customers can use to mitigate the risk.

At a minimum, an institution's layered security program should (1) detect and respond to suspicious activity and (2) control administrative functions. To detect and respond to suspicious activities, appropriate control processes should be instituted that detect anomalies and effectively respond to suspicious or anomalous activity related to initial login and authentication of customers requesting access to the institution's electronic banking system, as well as the initiation of electronic transactions involving the transfer of funds to other parties. Manual or automated transaction monitoring or anomaly detection and response may prevent instances of ACH/wire transfer fraud since fraudulent wire activities are typically anomalous when compared with the customer's established patterns of behavior.

A layered security program should also control administrative functions. For business accounts, layered security should include enhanced controls for system administrators who are granted privileges to set up or change system configurations, such as setting access privileges and application configurations and/or limitations. These enhanced controls should exceed the controls applicable to routine business customer users. For example, a preventive control could include requiring an additional authenti-

*Examination Handbook*, Information Security Booklet, July 2006, Key Concept section.

7. See Interagency Final Regulation Guidelines on Identity Theft Red Flags, 12 CFR parts 41, 222, 334, 571, and 717; Interagency Guidelines Establishing Information Security Standards, 12 CFR parts 30, 208, 225, 364, and 570, Appendix B. See also Section 4060.1 under "Identity Theft Red Flags Program" for further details and examination procedures.

cation routine or a transaction verification routine prior to final implementation of the access or application changes. An example of a detective control could include a transaction verification notice immediately following implementation of the submitted access or application changes. Out-of-band authentication, verification, or alerting can be effective controls. Overall, enhanced controls over administrative access and functions can effectively reduce money transfer fraud.

While the technical aspect of information security considerations for electronic banking activities is complex, widely used turnkey software applications for Internet banking generally conform to accepted industry standards for technical security. Detailed assessments of the technical security of specific systems are the responsibility of the institution and its qualified engineers and internal and external auditors. Examiners should focus on the institution's implementation of key security controls for the particular software application.

Any security breaches of an institution's electronic banking service or web site that may lead to potential financial losses or disclosure of sensitive information should be reported to an appropriate management level within the institution. If necessary, the appropriate suspicious-activity report should be filed. Institutions should ensure that their service providers notify them of any computer security breaches in their operations that may affect the institution. Institutions should determine the cause of any such intrusions and develop an appropriate plan to limit any resulting financial losses to the bank and its customers and to prevent recurrence.

### *Passwords and System-Access Controls*

Most institutions use identifiers such as account numbers or ATM card numbers, together with passwords or PINs, to verify the authorization of users accessing the retail electronic banking system. (Wholesale or corporate cash-management systems may use more secure methods, such as smart cards that contain customer credentials, real-time passwords (passwords that can be immediately changed online), or dedicated terminals, to authenticate users.) Prudent password-administration procedures generally require that customer passwords be changed if compromised and that passwords do not auto-

matically default to easily guessed numbers or names. Passwords and PINs are (1) generally encrypted while in transit or storage on insecure networks or computers, (2) suppressed on screen when entered on a keyboard, and (3) suspended after a predetermined number of failed log-in attempts. Institutions should establish clear policies and procedures for retrieving or resetting customer passwords when customers lose or forget their password to minimize the risk that passwords are disclosed to unauthorized individuals.<sup>8</sup>

### *Firewalls*

A firewall is a security control consisting of hardware, software, and other security measures established to protect the bank's internal data and networks, as well as its web sites, from unauthorized external access and use through the Internet. A number of banks and their vendors use various firewall products that meet industry standards to secure their Internet banking services, web sites, and other bank networks. For a firewall to adequately protect a bank's internal networks and systems, it must be properly installed and configured. Firewalls are most effective when all updates and patches to the firewall systems are installed and when the firewall configuration is reassessed after every system change or software update.

### *Viruses*

Computer viruses can pose a threat to information systems and networks that are connected to the Internet. In addition to destroying data and possibly causing system failure, viruses can potentially establish a communication link with an external network, allow unauthorized system access, or even initiate unauthorized data transmission. Widely used protection measures include using anti-virus products that are installed and are resident on a computer or network or providing for virus scanning during downloads of information or the execution of any program. Bank employees and electronic banking customers should be educated about the risks posed to systems by viruses and other malicious programs, as well as about the proper procedures for accessing information to help avoid these threats.

<sup>8</sup>. See SR-05-19 for further information on password-administration practices.

## *Encryption of Communications*

Information transmitted over the Internet may be accessible to parties other than the sender and receiver. As a result, most retail electronic commerce services use industry-standard secure sockets layer (SSL) technology to encrypt sensitive transactional information between the customer and the web site to minimize the risk of unauthorized access to this information while it is in transit. Although stronger encryption techniques may be warranted for higher-value corporate or wholesale transactions, SSL is generally considered adequate for retail Internet banking transactions.

In addition, many banks accept communications through standard Internet e-mail; in some cases, account applications containing sensitive customer data may be sent to the bank. These communications are generally not protected by SSL or a similar technology but are open to potential unauthorized access. If the electronic banking system does not provide for encrypted e-mail, the bank should ensure that customers (and customer-service representatives) are alerted not to send confidential information by unencrypted e-mail.

## *Security Testing and Monitoring*

Assessments of information security vulnerability, penetration testing, and monitoring help ensure that appropriate security precautions have been implemented and that system security configurations are appropriate. Some institutions contract with third-party security experts to provide these services. Vulnerability assessments provide an overall analysis of system security and report any system vulnerabilities. Such assessments can detect known security flaws in software and hardware, determine system susceptibility to known threats, and identify vulnerabilities such as settings that are contrary to established security policies.

Penetration testing and vulnerability assessments identify an information system's vulnerability to intrusion. Penetration tests examine system security by mimicking external intrusion attempts to circumvent the security features of a system. However, a penetration test is only a snapshot in time and does not guarantee that the system is secure.

Intrusion detection is an ongoing process that monitors the system for intrusions and unusual

activities. Intrusion-detection systems, which can be installed on individual computers and at locations on a network, can be configured to alert appropriate system personnel to potential intrusions at the time they occur. In addition, the detection systems provide ongoing reporting and monitoring of unusual events such as potential intrusions or patterns of misuse.

## Customer Awareness and Education

Because customer awareness is a key defense against fraud and identity theft, financial institutions should make efforts to educate their customers. Institutions should evaluate their consumer education efforts to determine if additional steps are necessary. The June 29, 2011, "Supplement to Authentication in an Internet Banking Environment" states that financial institution's customer awareness and educational efforts should address both retail and commercial account holders and, at a minimum, include the following elements:

- an explanation of protections provided, and not provided, to account holders relative to electronic funds transfers under Regulation E, and a related explanation of the applicability of Regulation E to the types of accounts with Internet access
- an explanation of under what, if any, circumstances and through what means the institution may contact a customer on an unsolicited basis and request the customer's provision of electronic banking credentials
- a suggestion that commercial online banking customers perform a related risk assessment and controls evaluation periodically
- a listing of alternative risk control mechanisms that customers may consider implementing to mitigate their own risk, or alternatively, a listing of available resources where such information can be found
- a listing of institutional contacts for customers' discretionary use in the event they notice suspicious account activity or experience customer information security-related events

## Contingency Planning

Periodic downtime and outages are common with online services. But when the duration or

disruption of these outages is significant, it can lead to reputational risk for the institution. For many institutions, short disruptions of electronic banking services may not have a material effect on their operations or customers, as other delivery channels are available. Nevertheless, electronic banking services should be covered by an institution's business-continuity plans. Institutions should assess their disaster-recovery needs by considering the length of time that electronic banking services could be unavailable to customers or for internal processing, and then design backup capabilities accordingly. In some cases, institutions may need to establish the capability to move processing to a different network or data center, or to move electronic banking services to a backup web site.

Typically, the electronic banking system includes capabilities to generate backup files on tapes, diskettes, or other portable electronic media containing key transaction and customer data. Web site information should also be subject to periodic backup. Security and internal controls at backup locations should be as sophisticated as those in place at the primary site. If a bank outsources electronic banking operations to a service provider, the institution should have a full understanding of the service pro-

vider's contingency and business-recovery commitments.<sup>9</sup>

## Outsourcing Arrangements

Many institutions outsource electronic banking operations to an affiliate or third-party vendor. In addition to operating the Internet banking software application, service providers may provide services such as web site hosting and development, Internet access, and customer service or call-center maintenance. As with other areas of a bank's operations, examiners should evaluate the adequacy of the institution's oversight of its critical service providers.<sup>10</sup>

Banking organizations should consider requiring Internet banking service providers to obtain periodic security reviews performed by an independent party. The client institution should receive reports summarizing the findings.

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9. For additional information on business resumption and contingency planning in relation to outsourcing, see section 4060.1, "Information Technology;" and the *FFIEC Information Systems Examination Handbook*.

10. See section 4060.1, "Information Technology;" and the *FFIEC Information Systems Examination Handbook* for information on risk management for outsourcing arrangements.

# Electronic Banking Examination Objectives

Effective date November 2001

## Section 4063.2

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1. To develop an understanding of the significance of the bank's electronic banking activities within and across business lines.
2. To assess the types and levels of risks associated with the bank's electronic banking activities.
3. To exercise appropriate judgment when determining the level of review, given the characteristics, size, and business activities of the organization.
4. To assess the current and potential impact of electronic banking activities on the institution's financial profile and condition.
5. To assess the adequacy of risk management and oversight of electronic banking activities, including outsourced activities.
6. To determine if the institution is complying with other applicable laws, rules and regulations.
7. To prepare examination report comments on significant deficiencies and recommended corrective action.
8. To determine the impact, if any, of electronic banking risks on the CAMELS rating, information technology rating, and risk-management ratings.
9. To update the workpapers with any information that will facilitate future examinations.

# Electronic Banking Examination Procedures

Effective date October 2011

## Section 4063.3

1. Identify the bank's current and planned electronic banking activities and review the bank's public Internet web sites. Consider whether the bank provides the following types of services:
  - a. telephone banking
  - b. retail Internet banking services
  - c. corporate or wholesale Internet banking services
  - d. Internet service provider (ISP)
  - e. brokerage services over the Internet
  - f. insurance services over the Internet
  - g. trust services over the Internet
  - h. account aggregation
  - i. electronic bill payment
  - j. other activities (for example, web portals, financial calculators, cross-marketing arrangements and alliances, or unique services)
2. Review prior examination findings and workpapers related to electronic banking, including consumer compliance, information technology, and other examination areas that may be relevant.
3. Determine if material changes have been made to electronic banking products, services, or operations since the last examination and if any significant changes are planned in the near future.
  - a. Ensure the bank has reviewed and updated the existing risk assessment prior to implementing new electronic financial services.
  - b. If the bank has not materially changed its electronic banking services, determine if the board or senior management has reviewed the risk assessment within the past 12 months.
4. Determine the significance of the bank's electronic banking activities. Consider the following areas:
  - a. approximate percentages and numbers of customers (for example, loan and deposit) that regularly use electronic banking products and services
  - b. lending and deposit volumes generated from Internet applications
  - c. the current monthly transaction and dollar volume for electronic banking services
  - d. costs and fees to operate the system and related services or marketing programs
5. Incorporate an analysis of electronic banking activities into risk assessments, supervisory plans, and scope memoranda, considering the size, activities, and complexity of the organization, as well as the significance of the activities across particular business lines.
6. Assess the level of risk and the current or potential impact of electronic banking activities on the organization's earnings, liquidity, asset quality, operational risk, and consumer compliance. Communicate any concerns to examiners reviewing these areas.
7. Determine if the bank operates its web sites, electronic banking systems, or core data processing systems internally and whether any activities are outsourced to a vendor. If outsourced, all activities should be supported by written agreements that have been reviewed by the bank's legal counsel. Identify the location of the following operations:
  - a. design and maintenance of the bank's public web site or home page
  - b. computer or server for the bank's public web site
  - c. development and maintenance of the bank's electronic banking systems
  - d. computer or server for the bank's electronic banking systems
  - e. customer service (for example, a call center) for electronic banking services
  - f. electronic bill-payment processing or other ancillary services
8. If the bank operates the electronic banking system or core data processing system in-house, review the topology (schematic diagram) of the systems and networks, and determine whether there is a direct, online connection between the bank's core processing systems and the electronic banking system.
9. If the bank operates the electronic banking system or core data processing system in-house, review the transaction-processing flows between the electronic banking system and the bank's core processing systems and identify key control points. Determine whether information is exchanged in a real-time, batch (overnight), or hybrid-processing mode.

10. Review any available audits or third-party reviews of vendors or service providers the bank uses, such as Service Organization Control Reports (formerly SAS 70 reports).<sup>1</sup> Review any Federal Financial Institutions Examination Council (FFIEC) Shared Application Software Review (SASR) reports or any FFIEC or other supervisory examination reports of service providers that the institution uses.
11. Determine the adequacy of risk management for electronic banking activities (including authentication methods for prospective and existing customers), given the level of risk these activities pose to the institution.<sup>2</sup> Complete or update relevant portions of the electronic banking internal control questionnaire as needed for the specific electronic banking activities identified in the previous steps of these procedures to evaluate the adequacy of—
  - a. policies and procedures governing electronic banking activities,
  - b. internal controls and security for electronic banking activities,
  - c. audit coverage for electronic banking activities,
  - d. monitoring and compliance efforts,
  - e. vendor and outsourcing management, and
  - f. board and management oversight.
12. Determine if the bank engages in any “high-risk” transactions involving access to customer information or the movement of funds to other parties.
  - a. If the bank engages in high-risk transactions, ensure the institution has implemented a layered security program and does not rely solely on any single control for authorizing such transactions.<sup>3</sup>
  - b. Ensure the bank’s layered security program is consistent with the risk for covered consumer and business (commercial) transactions.
13. Perform additional analysis and review, consulting with information technology specialists, consumer compliance specialists, or other subject-matter experts as needed, on areas of potential concern.
14. Determine the impact of any electronic banking activities or internal-control deficiencies on the financial condition of the organization.
15. Determine the extent of supervisory attention needed to ensure that any weaknesses are addressed and that associated risk is adequately managed.
16. Determine the impact of any deficiencies on the CAMELS rating, information technology rating, operational-risk rating, and any other relevant supervisory ratings.
17. Prepare comments for the examination report on any significant deficiencies and recommended corrective action.
18. Update the workpapers with any information that will facilitate future examinations.

1. Effective June 15, 2011, the Statement on Standards for Attestation Engagements (SSAE) No. 16, “Reporting on Controls at a Service Organization,” replaces the guidance for service auditors in the American Institute of Certified Public Accountants (AICPA) Statement of Auditing Standards (SAS) No. 70 “Service Organizations.”

2. See SR-05-19, “FFIEC Guidance on Authentication in an Internet Banking Environment,” and SR-11-19, “Inter-agency Supplement to Authentication in an Internet Banking Environment.”

3. See SR-11-9 and Section 4063.1.



# Electronic Banking Internal Control Questionnaire

Effective date May 2007

## Section 4063.4

Review the bank's internal controls, policies, practices, and procedures for electronic banking activities. Complete those questions necessary to assess whether any potential concerns warrant further review.

### POLICIES AND PROCEDURES

1. Are updates and changes to the bank's public web sites—
  - a. made only by authorized staff?
  - b. subject to dual verification?
2. Are web site information and links to other web sites regularly verified and reviewed by the bank for—
  - a. accuracy and functionality?
  - b. potential reputational, compliance, and legal risk?
  - c. appropriate disclaimers?
3. Do operating policies and procedures include—
  - a. procedures for and controls over the opening of new customer accounts submitted through electronic channels in order to verify potential customer identity and financial condition?
  - b. single-factor and tiered single-factor or multifactor procedures for authenticating the identity of prospective and existing customers when administering access to the electronic banking system (for example, customer passwords, personal identification numbers (PINs), or account numbers)?
  - c. requirements for review of or controls over wire transfers or other large transfers initiated through the electronic banking system, to watch for potentially suspicious activity?
  - d. appropriate authorizations for electronic debits initiated against accounts at other institutions, if such transfers are allowed?
  - e. depending on the type of account, dollar limits on transactions over a given time period initiated through the electronic banking service?
  - f. reconciliation and accounting controls over transactions initiated through the electronic banking system, including electronic bill-payment processing?

4. Do written information security policies and procedures address electronic banking products and services?
5. Are business-recovery procedures adequate? Do the procedures address—
  - a. events that could affect the availability of the electronic banking system, such as system outages, natural disasters, or other disruptions?
  - b. planned recovery times that are consistent with how important electronic banking activities are to the institution?
6. Has management established an adequate incident-response plan to handle and report potential system security breaches, web site disruptions, malicious tampering with the web site, or other problems?

### AUDIT AND INDEPENDENT REVIEW

1. Do the bank's internal and external audit programs address electronic banking activities and systems?
2. Is the level of audit review commensurate with the risks in electronic banking activities and systems?
3. Do audits address—
  - a. the review and testing of the bank's internal controls relating to electronic banking?
  - b. the review of service-provider performance relative to contract terms, if services are outsourced?
  - c. the review of the service providers' internal or external audits or third-party reviews, if services are outsourced?
4. Is management's response to any audit recommendations timely and appropriate?

### INTERNAL CONTROLS AND SECURITY

1. Has the bank or service provider implemented a firewall to protect the bank's web site?
2. Are ongoing monitoring and maintenance arrangements for the firewall in place to ensure that it is properly maintained and configured?



3. If the bank uses a turnkey electronic banking software package or outsources to a service provider—
  - a. are bank staff familiar with key controls detailed by the vendor's security and operating manuals and training materials?
  - b. are workstations that interface with the service provider's system for administrative procedures or for the transfer of files and data kept in a secure location with appropriate password or other access control, dual-verification procedures, and other controls?
4. Does the bank's control of customer access to the electronic banking system include—
  - a. procedures to ensure that only appropriate staff are authorized to access electronic banking systems and data, including access to any workstations connected to a remote system located at a service provider?
  - b. levels of authentication methods that are commensurate with the level of risk in the bank's electronic banking applications?
  - c. the length and composition of passwords and PINs?
  - d. encryption of passwords and PINs in transit and storage?
  - e. the number of unsuccessful log-on attempts before the password is suspended?
  - f. procedures for resetting customer passwords and PINs?
  - g. automatic log-off controls for user inactivity?
5. Have security-vulnerability assessments and penetration tests of electronic banking systems been conducted? Has the bank reviewed the results?
6. Has the bank or its service provider established—
  - a. an intrusion-detection system for electronic banking applications?
  - b. procedures to detect changes in electronic banking files and software?
  - c. measures to protect the electronic banking system from computer viruses?
  - d. procedures for ensuring on an ongoing basis that electronic banking applications, operating systems, and the related security infrastructure incorporate patches and upgrades that are issued to address known security vulnerabilities in these systems?
7. If e-mail is used to communicate with customers, are communications encrypted or does the bank advise customers not to send confidential information through e-mail?

## MONITORING AND COMPLIANCE

1. Are adequate summary reports made available to management to allow for monitoring of—
  - a. web site usage?
  - b. transaction volume?
  - c. system-problem logs?
  - d. exceptions?
  - e. unreconciled transactions?
  - f. other customer or operational issues?
2. Has management established adequate procedures for monitoring and addressing customer problems with electronic banking products and services?
3. Does management accurately report its primary public web-site address on its Consolidated Report of Condition and Income?
4. Have required Suspicious Activity Report by Depository Institutions (SAR-DI) forms involving electronic banking, including any computer intrusions, been filed? See SR-07-2 and the attached June 2007 SAR-DI form, the requirements for suspicious-activity reporting in section 208.62 of the Board's Regulation H (12 CFR 208.62), and the Bank Secrecy Act compliance program in section 208.63 (12 CFR 208.63).

## VENDORS AND OUTSOURCING

1. Is each significant vendor, service provider, consultant, or contractor relationship that is involved in the development and maintenance of electronic banking services covered by a written, signed contract? Depending on the nature and criticality of the services, do contracts specify—
  - a. minimum service levels and remedies or penalties for nonperformance?
  - b. liability for failed, delayed, or erroneous transactions processed by the service provider and for other transactions in which losses may be incurred (for example, insufficient funds)?
  - c. contingency plans, recovery times in the event of a disruption, and responsibility

- for backup of programs and data?
- d. data ownership, data usage, and compliance with the bank's information security policies?
  - e. bank access to the service provider's financial information and results of audits and security reviews?
  - f. insurance to be maintained by the service provider?
2. Has legal counsel reviewed the contracts to ensure they are legally enforceable and that they reasonably protect the bank from risk?
  3. Has the bank ensured that any service provider responsible for hosting or maintaining the bank's web site has implemented—
    - a. controls to protect the bank's web site from unauthorized alteration and malicious attacks?
    - b. procedures to notify the bank in the event of such incidents?
    - c. regular backup of the bank's web site information?
  4. Depending on the nature and criticality of the services, does the bank conduct initial and periodic due-diligence reviews of service providers, including—
    - a. reviewing the service provider's standards, policies, and procedures relating to internal controls, security, and business contingency to ensure they meet the bank's minimum standards?
    - b. monitoring performance relative to service-level agreements and communicating any deficiencies to the service provider and to bank management?
    - c. reviewing reports provided by the service provider on response times, availability and downtime, exception reports, and capacity reports, and communicating any concerns to bank management and the vendor?
    - d. periodically reviewing the financial condition of the service provider and determining whether backup arrangements are warranted as a result?
    - e. reviewing third-party audits, SAS 70 reports, and regulatory examination reports on the service provider, if available, and following up on any findings with the service provider?
    - f. conducting on-site audits of the service provider, if appropriate based on the level of risk?
    - g. participating in user groups?
    - h. ensuring the bank's staff receives adequate training and documentation from the vendor or service provider?
  5. If the bank operates a turnkey electronic banking software package—
    - a. is software held under an escrow agreement?
    - b. has the bank established procedures to ensure that relevant program files and documentation held under the software escrow agreement are kept current and complete?
  6. If a vendor maintains the bank's electronic banking system, does the bank monitor the on-site or remote access of its systems by the vendor, through activity logs or other measures?

## BOARD AND MANAGEMENT OVERSIGHT

1. Does the board or an appropriate committee approve the introduction of new electronic banking products and services on the basis of a written business plan and risk analysis that are commensurate with the proposed planned activity?
2. Has the bank considered—
  - a. whether the service is designed to provide information on existing services to existing customers or to attract new customers?
  - b. whether financial incentives will be offered to attract customers through the electronic banking service? What is the financial impact of such incentives on the bank?
  - c. the potential impact of electronic banking products and services on the composition of the bank's customer base?
  - d. the projected financial impact of the new service, including up-front and operating costs and any impact on fees or other revenue or expenses?
  - e. internal controls appropriate for the new product or service?
  - f. whether adequate management reports are provided and subject to periodic review?
  - g. whether any new nonbanking activities are permissible under applicable state and federal banking laws?
  - h. the extent of outsourcing and responsi-

bilities for managing vendor and service-provider relationships?

3. Has the bank evaluated the adequacy of its insurance coverage to cover operational risks in its electronic banking activities?
4. Has the bank's legal counsel been involved in the development and review of electronic banking agreements (for example, agree-

ments with third-party vendors)? Has the bank's legal counsel also been involved in the development and review of its authentication methods to ensure that the methods provide a foundation to enforce agreements and transactions and to validate the parties involved, consistent with applicable state laws?

Dividends are distributions of earnings to owners.<sup>1</sup> Dividends can influence an investor's willingness to purchase corporate stock since the investor generally expects reasonable investment returns. Although dividends usually are declared and paid in either cash or stock, occasionally they are used to distribute real or personal property. Dividend payments may reduce capital in some banks to the point of supervisory concern. Accordingly, on November 14, 1985, the Federal Reserve Board issued a policy statement on the payment of dividends by state member banks and bank holding companies. (See *Federal Reserve Regulatory Service* at 4–877. See also section 2020.5, “Intercompany Transactions (Dividends),” in the *Bank Holding Company Supervision Manual*.) In 2009, the Federal Reserve issued SR-09-4, “Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies,” which provides guidance on the declaration and payment of dividends, capital redemptions, and capital repurchases by bank holding companies in the context of their capital planning processes. While SR-09-4 applies to bank holding companies, its principles are also broadly relevant to state member banks. In addition, certain statutory limitations apply to the payment of dividends.

Examiners should also be aware of a bank's parent company cash-flow needs. In addition to the payment of dividends, the parent company may need cash for debt service or to fund its operations. When establishing dividend levels from a bank subsidiary, the parent company should not set a dividend rate that will place undue pressure on the bank's ability to maintain an adequate level of capital.

Declaration of a dividend requires formal action by the board of directors to designate the medium of payment, dividend rate, shareholder record date, and date of payment. Dividends

may be declared at the discretion of the board.<sup>2</sup> Dividends are recorded on the bank's books as a liability (dividends payable) on the date of declaration.

### SUMMARY OF POLICY STATEMENT ON PAYMENT OF DIVIDENDS

Adequate capital is critical to the health of individual banking organizations and to the safety and stability of the banking system. A major determinant of a financial institution's capital adequacy is earnings strength and whether earnings are retained or paid to shareholders as cash dividends. Dividends are the primary way that banking organizations provide return to shareholders on their investment.

During profitable periods, dividends represent a return of a portion of a banking organization's net earnings to its shareholders. During less profitable periods, dividend rates are often reduced or sometimes eliminated. The payment of cash dividends that are not fully covered by earnings, in effect, represents the return of a portion of an organization's capital at a time when circumstances may indicate instead the need to strengthen capital and concentrate financial resources on resolving the organization's problems.

As a matter of prudent banking, therefore, a bank or bank holding company generally should continue its existing rate of cash dividends on common stock only if—

- the organization's net income available to common shareholders over the past year has been sufficient to fully fund the dividends; and
- the prospective rate of earnings retention appears consistent with the organization's capital needs, asset quality, and overall financial condition.

1. Other payments not called dividends may also be distributions of earnings to owners. These distributions or “constructive dividends” may be termed fees, bonuses, or other payments. Constructive dividends are distinct from legitimate fees, bonuses, and other payments, which are reasonable, adequately documented, and for valuable goods and services provided to the bank. Constructive dividends may create a potential tax liability and indicate control issues or insider self-dealing, and they may portend shareholder lawsuits against insiders, board members, and the bank.

2. At a minimum, board of directors minutes approving declaration and payment of a dividend should include three components: (1) the “as of” date to identify shareholders of record to receive the dividend (date of record), (2) an amount or description of the dividend, and (3) identification of the date on which the dividend payment is to take place (date of payment). There may also be additional legal requirements that should be documented, depending on state laws and the nature of the dividend.

Any banking organization whose cash dividends are inconsistent with either of these criteria should seriously consider reducing or eliminating its dividends. Such an action will help conserve the organization's capital base and help it weather a period of adversity.

A banking organization that is experiencing financial problems or that has inadequate capital should not borrow to pay dividends; this would result in increased leverage at the very time the organization needs to reduce its debt or conserve its capital. Similarly, the payment of dividends based solely or largely on gains resulting from unusual or nonrecurring events may be imprudent. Unusual or nonrecurring events may include the sale of assets, the effects of accounting changes, the postponement of large expenses to future periods, or negative provisions to the allowance for loan and lease losses.

## STATUTORY LIMITATIONS

Three major federal statutory limitations govern the payment of dividends by banks. These limitations, included in sections 1831o, 56, and 60 of title 12 of the United States Code (12 USC 1831o, 56, and 60), apply to cash dividends or property dividends paid with assets other than cash. However, common stock dividends (dividends payable in common stock to all the common shareholders of the bank) may be paid regardless of the statutory limitations since such dividends do not reduce the bank's capital. In addition, the examiner needs to be aware of any state laws governing dividend payments.

### Prompt Corrective Action

Section 1831o, also referred to as the prompt-corrective-action (PCA) provision, was adopted in 1991 as part of the Federal Deposit Insurance Corporation Improvement Act. Section 1831o applies to all insured depository institutions, including state member banks, and is implemented through section 208.40 of Regulation H. This regulatory section prohibits the payment of dividends when a bank is deemed to be undercapitalized or when the payment of the dividend would make the bank undercapitalized in accordance with the PCA framework. An organization that is undercapitalized for purposes of PCA must cease paying dividends for as long as

it is deemed to be undercapitalized. Once earnings have begun to improve and an adequate capital position has been restored, dividend payments may resume in accordance with federal and state statutory limitations and guidelines.

### Sections 56 and 60

Sections 56 and 60 (sections 5204 and 5199 of the Revised Statutes) were first adopted as part of the National Bank Act more than 100 years ago. Although these sections were made applicable to national banks, they also apply to state member banks under the provisions of section 9 of the Federal Reserve Act.<sup>3</sup> These sections are implemented through section 208.5 of Regulation H.

Under section 56, prior regulatory and shareholder approval must be obtained if the dividend would exceed the bank's undivided profits (retained earnings), as reportable in its Reports of Condition and Income (Call Reports).<sup>4</sup> In addition, the bank may include amounts contained in its surplus account, if the amounts reflect transfers made in prior periods of undivided profits and if regulatory approval for the transfer back to undivided profits is obtained.

Under section 60, prior regulatory approval to declare a dividend must be obtained if the total of all dividends declared during the calendar year, including the proposed dividend, exceeds the (1) sum of the net income earned during the year-to-date and (2) the retained net income of the prior two calendar years as reported in the bank's Call Reports. In determining this limitation, any dividends declared on common or preferred stock during the period and any required transfers to surplus or a fund for the retirement of any preferred stock must be deducted from net earnings to determine the net income and retained net income.<sup>5</sup>

3. State-chartered banks that are not members of the Federal Reserve System (state nonmember banks) are not subject to sections 56 and 60. However, they may be subject to similar dividend restrictions under state law.

4. Although the language of section 56 could imply that a dividend cannot be declared in excess of the limit even if regulatory approval were obtained, a "return of capital" to shareholders is allowed under section 59 if the bank obtains prior regulatory approval and the approval of at least two-thirds of each class of shareholders.

5. In rare circumstances when the surplus of a state member bank is less than what applicable state law requires the bank to maintain relative to its capital stock account, the bank may be required to transfer amounts from its undivided

The statutory limitations are tied to the declaration date of the dividend because, at that time, shareholders expect the dividends will be paid, a liability is recorded, and the bank's capital is reduced. If the bank's board of directors wishes to declare a dividend between Call Report dates, the earnings or losses incurred since the last Call Report date should be considered in the calculation. Thus, if a bank's dividend-paying capacity might be limited under sections 56 or 60, the bank should ensure it has sufficient capacity to declare the dividend by maintaining sufficient documentation to substantiate its earnings or losses on an accrual basis for the period since the last Call Report date.

## REQUEST FOR REGULATORY APPROVAL

When regulatory approval is required for divi-

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profits account to surplus. This may arise, for example, because some states require surplus to equal or exceed 100 percent of the capital stock account. Such required transfers would reduce the section 60 calculation.

dividend payments under section 56 or 60, the request should be submitted to the appropriate Federal Reserve Bank. In section 265.11(e)(4) of the Rules Regarding Delegation of Authority, the Reserve Banks have been delegated authority to permit a state member bank to declare dividends in excess of section 60 limits. Before approving the request, the Reserve Bank should consider if the proposed dividend is consistent with the bank's capital needs, asset quality, strength of management, and overall financial condition.

If applicable, examiners should verify that prior approval was obtained from the Federal Reserve Bank, and, if required, at least two-thirds of each class of stockholders before the dividend was paid. Violations of law or nonconformance with the Federal Reserve Board's policy statement should be discussed with bank management and noted in the examination report.

# Dividends

## Examination Objectives

Effective date May 1996

## Section 4070.2

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1. To determine if the policies, practices, procedures, and internal controls regarding dividends are adequate and whether they are being followed.
2. To determine if bank directors, officers, and employees are operating in compliance with the established guidelines.
3. To evaluate the propriety and consistency of the bank's present and planned dividend policy in light of existing conditions and future plans.
4. To determine that the scope of the audit function is adequate.
5. To determine if any dividends declared exceed the section 1831o limitation, and, if so, to inform the enforcement section of the Federal Reserve Bank.
6. To determine if any dividends declared exceed the section 56 and 60 limitations, and, if so, whether the respective required approvals from the Federal Reserve Bank and shareholders were obtained.
7. To determine whether the dividend payments comply with the Board's policy statement concerning dividend payments of banks and bank holding companies.
8. To determine compliance with other applicable laws and regulations.
9. To initiate corrective action when policies, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

# Dividends

## Examination Procedures

Effective date April 2011

## Section 4070.3

1. If selected for use, complete or update the internal control questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls. Also obtain a listing of any deficiencies noted in the latest internal or external auditor reports from the examiner who is assigned to internal control. Determine if appropriate corrective action has been taken.
4. a. If dividends were declared since the last examination, complete the dividend-limitations worksheets to determine whether the bank was in compliance with the following sections of the U.S. Revised Statutes, as they are interpreted by section 208.5 of Regulation H:
  - section 5199 (12 USC 60), which establishes a restriction based on the current and prior two years' retained net income, as adjusted for required transfers to surplus or transfers to a fund for the retirement of any preferred stock. Table 1 on the next page may be used for the calculation.
  - section 5204 (12 USC 56), which establishes a restriction on dividends based on the bank's retained earnings (undivided profits), as adjusted for any surplus transferred, with prior regulatory approval, as needed, back to undivided profits and the excess, if any, of credit losses or other losses derived from extensions of credit over the allowance for loan and lease losses (ALLL).<sup>1</sup>
- b. For the calculations in table 1, determine whether the dividend exceeded the section 56 or 60 limits and, if so, whether the dividend received prior approval. Dividends declared in excess of the section 56 limitation must receive prior Federal Reserve approval and approval by at least two-thirds of the shares of each class of stock outstanding, pursuant to 12 USC 59. Dividends declared in excess of the section 60 limitation must receive prior Federal Reserve approval.
5. Review the examination findings with the examiner-in-charge in preparation for discussion with appropriate management.
6. Prepare examination-report comments on the bank's dividend practices, including any deficiencies noted.
7. Update the workpapers with the current dividend-limitations worksheets, as well as any information that will facilitate future examinations.

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1. Although section 56 seems to indicate that a bank should deduct its credit losses from its undivided profits, this adjustment is not generally necessary. Under generally accepted accounting principles, banks reserve for bad debts in the ALLL, which reduces the bank's undivided profits. Banks should deduct only the excess of credit losses in excess of the bank's ALLL, and such excess should rarely occur. The second part of table 1 illustrates the section 56 dividend-limitation calculation.



Table 1—Dividend-Limitation Computations

References to schedules in this table are to the schedules in the Consolidated Reports of Condition and Income (bank Call Reports).

## Section 60 Computation

## Section 56 Computation

	Year					Year
	20_	20_	20_	Total		20_
Net income (loss) (schedule RI, item 12)	—	—	—	—	Retained earnings (undivided profits) (schedule RC, item 26a)	—
Less:						
Required transfers to surplus under state law (generally zero) or transfers to a fund for the retirement of any preferred stock	—	—	—	—	Add:	
					Surplus in excess of state regulatory requirements that was earned and is transferred, with prior regulatory approval, back to undivided profits	—
Less:					Less:	
Common and preferred stock dividends declared (schedule RI-A, item 8 + item 9)	—	—	—	—	Loan losses or other losses derived from extensions of credit that are in excess of the allowance for loan and lease losses	—
Retained net profits available for dividends before adjustments	—	—	—	—	Section 56 limitation	—
Adjustments for dividends in excess of income (if any) <sup>1</sup>	—	—	—	—		
Retained net profits available for dividends after adjustments	—	—	—	— <sup>2</sup>		

1. Any excess may be attributed to the prior two years by first applying the excess to the earlier year, and then the immediately preceding year, net of any previous-year adjustments. See section 208.5 of Regulation H for further guidance.

2. This is the section 60 limitation.

# Dividends

## Internal Control Questionnaire

Effective date September 1992

## Section 4070.4

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Review the bank's internal controls, policies, practices and procedures for paying dividends. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### GENERAL

1. Does the bank employ the services of an independent dividend paying agent?
- \*2. Has the board of directors passed a resolution designating those officers who are authorized to sign dividend checks?
- \*3. Are unused dividend checks under dual control?
- \*4. Does the bank's system require separation of duties regarding custody, authorization,

preparation, signing and distribution of dividend checks?

- \*5. Are dividend checks reconciled in detail before mailing?
- \*6. Is control maintained over the use of serially numbered dividend checks to ensure that they are issued sequentially?

### CONCLUSION

1. Does the foregoing information provide an adequate basis for evaluating internal control? If significant deficiencies in areas not included in this questionnaire impair controls, indicate additional examination procedures deemed necessary.
2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, is internal control considered adequate?

Employee benefit trusts are specialized trusts most commonly established to provide retirement benefits to employees. However, they may also be established for employee stock ownership or thrift purposes, or to provide medical, accident, and disability benefits. There are qualified and unqualified plans. Retirement plans are qualified under section 401 of the Internal Revenue Code (IRC), and employee benefit trusts are tax exempt under section 501(a) of the IRC. The major types of qualified plans are profit sharing, money purchase, stock bonus, employee stock ownership plans (ESOPs), 401(k) plans, and defined benefit pension plans.

Since 1974, state jurisdiction of employee benefit trusts and their administration has been largely preempted by a comprehensive scheme of federal laws and regulations under the Employee Retirement Income Security Act of 1974 (ERISA). ERISA is divided into four titles: Title I, "Protection of Employee Benefit Rights," includes the fiduciary responsibility provisions (in part 4) that are interpreted and enforced by the U.S. Department of Labor (DOL). Title II, "Amendments to the Internal Revenue Code Relating to Retirement Plans," is similar to Title I, but the Internal Revenue Service (IRS) is responsible for its enforcement. Title III, "Jurisdiction, Administration, Enforcement," grants jurisdiction and powers for administration to various governmental units. Title IV, "Plan Termination Insurance," establishes the Pension Benefit Guaranty Corporation (PBGC). The PBGC ensures that defined benefit plans have sufficient resources to provide minimum levels of benefits to participants. In addition to the PBGC, the primary agencies that have promulgated necessary regulations and interpretations pursuant to ERISA are the DOL and IRS. However, state and federal banking agencies also have a recognized role under this statute.

Numerous laws affecting employee benefit plans have been enacted since the adoption of ERISA; however, the most sweeping changes were imposed by the Tax Reform Act of 1986. These changes include (1) imposing numerous excise taxes on employers and employees for failure to meet new plan contribution and distribution rules, (2) lowering the maximum amount of contributions and benefits allowed under qualified defined contribution and defined benefit plans, (3) lowering the amount an individual can contribute to a 401(k) plan, and (4) provid-

ing new nondiscrimination rules covering plan contributions and distributions. Virtually all qualified plans had to be amended to comply with this law.

A specific statutory provision of ERISA mandates the exchange of information among federal agencies. Accordingly, the federal banking agencies have entered into an agreement with the DOL whereby a banking agency noting any possible ERISA violations that meet certain specific criteria will refer the matter to the DOL.

ERISA imposes very complex requirements on banks acting as trustees or in other fiduciary capacities for employee benefit trusts. Severe penalties can result from violations of statutory obligations. With respect to a bank's own employees' retirement plan, the bank (or "plan sponsor"), regardless of whether it is named trustee, is still a "party-in-interest" pursuant to the statute. Therefore, unless a transaction qualifies for narrowly defined statutory exemptions (or unless it is the subject of a specific "individual" exemption granted by the DOL), any transaction involving the purchase or sale of an asset of the plan from or to the bank, any affiliate, officer, or employee could constitute a prohibited transaction under ERISA.

The current and projected costs of employee benefit plans should be analyzed for their impact on the expenses and overall financial condition of the bank. Excessive pension or profit-sharing benefits, large expense accounts, employment contracts, or bonuses for officers or directors (especially if they are also large shareholders) could prove detrimental and even lead to civil liability for the bank or its board.

Depending on the type of plan and the allocations of its fiduciary duties, certain reporting, disclosure, and plan design requirements are imposed on the plan sponsor and/or its designated supervising committee. Therefore, a bank should have appropriate expertise, policies, and procedures to properly administer the type of employee benefit accounts established for its employees.

If an examiner, as part of any examination assignment, detects possible prohibited transactions, self-dealing, or other questionable activities involving the bank's employee benefit plan, an appropriate investigation should be undertaken. Substantial conversions of existing defined benefit plans or plan assets into holdings of bank or affiliate stock, under certain circumstances,

could involve ERISA violations. An examiner should refer a complicated question arising out of any of these situations to the examiner-in-charge for resolution or submission to the Reserve Bank.

Part I of the following examination procedures (section 4080.3) should be completed for every commercial bank examination; part II should also be completed if the employee bene-

fit plan is not trusted by the bank or by an affiliate bank subject to supervision by a federal banking agency. Parts I and II may be completed by a trust specialist, if available. When a bank trust department is named as trustee, the examiner should determine whether compliance with ERISA was reviewed during the previous trust examination. If not, then part II should be completed.

# Employee Benefit Trusts

## Examination Objectives

Effective date May 1996

Section 4080.2

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1. To determine if the policies, practices, procedures, internal controls, and available expertise regarding employee benefit trusts are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the impact of employee benefit plans and related benefits on the financial condition of the bank.
4. To determine compliance with laws, regulations, and instrument provisions.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, regulations, or the governing instruments have been noted.

# Employee Benefit Trusts

## Examination Procedures

Effective date December 1985

## Section 4080.3

### PART I

1. If selected for implementation, complete or update the Employee Benefit Trusts section of the Internal Controls Questionnaire.
2. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if appropriate corrections have been made.
3. Determine the approximate number, size and types of employee benefit plans held for the benefit of the bank's officers and employees.
4. Obtain plan instruments or amendments thereto (if any) and summarize key features for the work papers. As appropriate, add or update the following information:
  - a. Date of adoption of new plan or amendment and brief summary of the plan or amendment.
  - b. Parties or committees named trustee and (if different) person(s) responsible for making investment decisions.
  - c. Individuals, committees or outside parties named as responsible for plan administration.
  - d. Basic investment/funding characteristics (e.g., "non-contributory profit-sharing, up to 100% in own BHC stock;" "contributory defined benefit pension plan, purchasing diversified securities," etc.).
  - e. Latest Form 5500 (IRS) filed for plan (may be omitted if plan administrator is an affiliate bank or bank holding company).

*Example:* First Bank established a non-contributory profit sharing trust in 1975 for all officers and employees. Latest amendment, as of December 31, 19XX, made technical alterations to the vesting and forfeiture provisions. The most recent available valuation of the trust's assets, dated June 30, 19XX, indicated total assets of \$22,093,000 (market value). Assets were comprised of U.S. government securities

(42%), listed stocks (53%) and cash equivalents. Bank of \_\_\_\_\_, as trustee, has sole investment responsibility.

5. If a plan is a defined benefit pension plan, ascertain the actuarially-determined amount of unfunded pension liability, if any, and the bank's arrangements for amortization. (Note: Unfunded pension liability represents a contingent liability per instructions for the Report of Condition.)
6. Determine if the current and projected costs of the employee benefit plan(s) is reasonable in light of the bank's financial condition.

Complete part II of these procedures, if applicable, then continue to step 7, below. Part II is to be completed when a plan for the bank's employees is administered by the bank or a bank committee and is not trustee by the bank itself or an affiliate bank subject to supervision by a federal banking agency.

7. Determine whether any instances of possible violations of ERISA have been noted, and that as to each such instance, full information has been developed for current workpapers to support a referral to DOL pursuant to SR-81-697/TR-81-46.

*Note:* While the final decision on whether or not to make a referral to the DOL is to be made by the Board's staff after receipt of the report of examination, complete information should always be obtained regarding possible ERISA violations in the event the decision is made to refer the matter. If gathering certain of the information would impose an undue burden upon the resources of the examiners or the bank, Board's staff (Trust Activities Program) should be consulted. Where a significant prohibited transaction such as self dealing has taken place, the bank should be clearly informed that it is expected to undertake all such corrective and/or remedial actions as are necessary under the circumstances. One measure would be for the bank to apply to the DOL for a retroactive exemption under ERISA section 408(a).

8. Reach a conclusion concerning:
  - a. The adequacy of policies, practices and

- procedures relating to employee benefit trusts.
- b. The manner in which bank officers are operating in conformance with established policy.
  - c. The accuracy and completeness of any schedules obtained.
  - d. Internal control deficiencies or exceptions.
  - e. The quality of departmental management.
  - f. Other matters of significance.
9. Prepare in appropriate report format, and discuss with appropriate officer(s):
    - a. Violations of laws and regulations.
    - b. Recommended corrective action when policies, practices or procedures are deficient.
  10. Update the workpapers with any information that will facilitate future examinations.
- PART II**
1. Review plan asset listings, valuations, or printouts obtained for any instances of possible prohibited transactions (ERISA sections 406(a) and (b)). The listings should include holdings of:
    - a. Loans.
    - b. Leases.
    - c. Real Estate.
    - d. Employer stock or other securities or obligations.
    - e. Own bank time deposits.
    - f. Other assets which might constitute, or result from, prohibited transactions.
  2. Review transaction(s)/holding(s) in the previous step for conformity to:
    - a. ERISA provisions regarding employer securities or real estate (sections 407(a), (b) and (c)) and related regulations.
    - b. Statutory exemptions of ERISA (section 408(b)).
    - c. "Exclusive benefit," prudence and diversification requirements of ERISA (sections 404(a) and (b)).

# Employee Benefit Trusts

## Internal Control Questionnaire

Effective date December 1985

## Section 4080.4

Review the bank's internal controls, policies, practices and procedures for employee benefit accounts. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Part I should be completed as part of every examination; both parts I and II should be completed whenever the plan, administered by the bank or a bank committee, is *not* trustee by the bank itself or by an affiliate bank subject to supervision by a federal banking agency.

### PART I

1. Are new employee benefit plans, significant amendments thereto, and related costs and features approved by the bank's board of directors?
- \*2. Does the institution obtain and maintain on file the following minimum documentation:
  - a. The plan and the corporate resolution adopting it?
  - b. IRS "determination" or "opinion" letter substantiating the tax-exempt status of the plan?
  - c. The trust agreement and the corporate resolution appointing the trustee(s), if applicable? (On occasion, fully insured plans may have no named trustee.)
  - d. Amendments to the plan or trust documents?
3. If the bank or a committee of its officers and employees acts as plan administrator for any plan(s), does it have internal procedures and/or has it arranged by contract for external administrative expertise sufficient to assure compliance with reporting, disclosure and other administrative requirements of ERISA and related regulations?
4. Have the bank, its officers, directors or employees, or any affiliate(s) entered into any transactions to buy or sell assets to the bank's employee benefit plan(s)?
5. Do plan investments conform to instrument investment provisions?

### PART II

1. When exercising fiduciary responsibility in

the purchase or retention of employer securities or employer real estate, does the bank have procedures to assure conformity with ERISA section 407 and related provisions?

*Note:* The requirements of ERISA and the associated DOL regulation with respect to "employer securities and employer real estate" include:

- a. A plan may not acquire or hold any but "qualifying employer securities and employer real estate."
  - b. A defined benefit plan may hold no more than 10 percent of the fair market value of its assets in qualifying employer securities and/or qualifying employer real property, except as provided by ERISA sections 407(a)(3) or 414(c)(1) and (2), and adopted regulations.
  - c. Any dispositions of such property from a plan to a party-in-interest shall conform to ERISA sections 414(c)(3) and (5) and adopted regulations, but certain acquisitions and sales may be made pursuant to the section 408(a) exemption.
  - d. The plan instrument, for an eligible individual account plan which is to hold in excess of 10 percent of the fair market value of its assets in qualifying employer securities or real property, shall provide explicitly the extent to which such plan may hold such assets. [ERISA sections 407(b)(1) and (d)(3)]
2. Does the bank have procedures to ensure conformance to the following statutory exemptions (and associated regulations) from the prohibited transactions provisions of ERISA:
    - a. Loans made by the plan to parties-in-interest who are participants or beneficiaries? [ERISA section 408(b)(1)]
    - b. Investment in deposits which bear a reasonable rate of interest of a bank which is a fiduciary of the plan? [ERISA section 408(b)(4)]

*Note:* Other statutory exemptions which may on occasion be applicable are:

    - c. Arrangements for office space or legal, accounting or other necessary services? [ERISA section 408(b)(2)]
    - d. Loans to employee stock ownership trusts? [ERISA section 408(b)(3)]



- e. Transactions between a plan and a collective trust fund maintained by a party-in-interest which is a bank or trust company? [section 408(b)(8)]
  - f. Providing of any ancillary service by a bank or trust company which is a fiduciary of the plan? [ERISA section 408(b)(6)]
3. If exercising or sharing fiduciary responsibility, does the bank have procedures designed:
- a. To ensure that duties are executed for the exclusive benefit of plan participants and beneficiaries, in accordance with the “prudent man” standard? [ERISA sections 404(a)(1)(A) and (B)]
  - b. To ensure that investments are diversified, unless it is clearly prudent not to do so or otherwise excepted by other provisions of ERISA? [ERISA section 404(a)(1)(C)]

Interest-rate risk (IRR) is the exposure of an institution's financial condition to adverse movements in interest rates. Accepting this risk is a normal part of banking and can be an important source of profitability and shareholder value. However, excessive levels of IRR can pose a significant threat to an institution's earnings and capital base. Accordingly, effective risk management that maintains IRR at prudent levels is essential to the safety and soundness of banking institutions.

Evaluating an institution's exposure to changes in interest rates is an important element of any full-scope examination and, for some institutions, may be the sole topic for specialized or targeted examinations. Such an evaluation includes assessing both the adequacy of the management process used to control IRR and the quantitative level of exposure. When assessing the IRR management process, examiners should ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain IRR at prudent levels with consistency and continuity. Evaluating the quantitative level of IRR exposure requires examiners to assess the existing and potential future effects of changes in interest rates on an institution's financial condition, including its capital adequacy, earnings, liquidity, and, where appropriate, asset quality. To ensure that these assessments are both effective and efficient, examiner resources must be appropriately targeted at those elements of IRR that pose the greatest threat to the financial condition of an institution. This targeting requires an examination process built on a well-focused assessment of IRR exposure before the on-site engagement, a clearly defined examination scope, and a comprehensive program for following up on examination findings and ongoing monitoring. This section provides examiner guidance for assessing both the adequacy of an institution's IRR management process and the quantitative level of its IRR exposure. The section begins with a description of the sources and effects of IRR, followed by a discussion of sound practices for managing IRR. The section then outlines examination considerations in assessing the quantitative level of IRR exposure. Finally, the section discusses key elements of the examination process used to assess IRR, including the role and importance of a preexamination risk assessment, proper scoping of the

examination, and the testing and verification of both the management process and internal measures of the level of IRR exposure.<sup>1</sup>

## SOURCES AND EFFECTS OF IRR

### Sources of IRR

As financial intermediaries, banks encounter IRR in several ways. The primary and most discussed source of IRR is differences in the timing of the repricing of bank assets, liabilities, and off-balance-sheet (OBS) instruments. Repricing mismatches are fundamental to the business of banking and generally occur from either borrowing short-term to fund longer-term assets or borrowing long-term to fund shorter-term assets. Such mismatches can expose an institution to adverse changes in both the overall level of interest rates (parallel shifts in the yield curve) and the relative level of rates across the yield curve (nonparallel shifts in the yield curve).

Another important source of IRR, commonly referred to as "basis risk," is the imperfect correlation in the adjustment of the rates earned and paid on different instruments with otherwise similar repricing characteristics (for example, a three-month Treasury bill versus a three-month LIBOR). When interest rates change, these differences can change the cash flows and earnings spread between assets, liabilities, and OBS instruments of similar maturities or repricing frequencies.

An additional and increasingly important source of IRR is the options in many bank asset, liability, and OBS portfolios. An option pro-

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1. This section incorporates and builds on the principles and guidance provided in SR-96-13, "Joint Policy Statement on Interest Rate Risk." It also incorporates, where appropriate, fundamental risk-management principles and supervisory policies and approaches identified in SR-93-69, "Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations"; SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies"; SR-96-14, "Risk-Focused Examinations and Inspections"; and SR-00-14, "Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations."

vides the holder with the right, but not the obligation, to buy, sell, or in some manner alter the cash flow of an instrument or financial contract. Options may be distinct instruments, such as exchange-traded and over-the-counter contracts, or they may be embedded within the contractual terms of other instruments. Examples of instruments with embedded options include bonds and notes with call or put provisions (e.g., callable U.S. agency notes), loans that give borrowers the right to prepay balances without penalty (e.g., residential mortgage loans), and various types of nonmaturity deposit instruments that give depositors the right to withdraw funds at any time without penalty (e.g., core deposits). If not adequately managed, the asymmetrical payoff characteristics of options can pose significant risk to the banking institutions that sell them. Generally, the options, both explicit and embedded, held by bank customers are exercised to the advantage of the holder, not the bank. Moreover, an increasing array of options can involve highly complex contract terms that may substantially magnify the effect of changing reference values on the value of the option and, thus, magnify the asymmetry of option payoffs.

## Effects of IRR

Repricing mismatches, basis risk, options, and other aspects of a bank's holdings and activities can expose an institution's earnings and value to adverse changes in market interest rates. The effect of interest rates on accrual or *reported earnings* is the most common focal point. In assessing the effects of changing rates on earnings, most banks focus primarily on their net interest income—the difference between total interest income and total interest expense. However, as banks have expanded into new activities to generate new types of fee-based and other non-interest income, a focus on overall net income is becoming more appropriate. The non-interest income arising from many activities, such as loan servicing and various asset-securitization programs, can be highly sensitive to changes in market interest rates. As non-interest income becomes an increasingly important source of bank earnings, both bank management and supervisors need to take a broader view of the potential effects of changes in market interest rates on bank earnings.

Market interest rates also affect the *value* of a bank's assets, liabilities, and OBS instruments and, thus, have a direct effect on the value of an institution's equity capital. The effect of rates on the *economic value* of an institution's holdings and equity capital is a particularly important consideration for shareholders, management, and supervisors alike. The economic value of an instrument is an assessment of the present value of its expected net future cash flows, discounted to reflect market rates.<sup>2</sup> By extension, an institution's economic value of equity (EVE) can be viewed as the present value of the expected cash flows on assets minus the present value of the expected cash flows on liabilities plus the net present value of the expected cash flows on OBS instruments. Economic values, which may differ from reported book values due to GAAP accounting conventions, can provide a number of useful insights into the current and potential future financial condition of an institution. Economic values reflect one view of the ongoing worth of the institution and can often provide a basis for assessing past management decisions in light of current circumstances. Moreover, economic values can offer comprehensive insights into the potential future direction of earnings performance since changes in the economic value of an institution's equity reflect changes in the present value of the bank's future earnings arising from its current holdings.

Generally, commercial banking institutions have adequately managed their IRR exposures and few have failed solely as a result of adverse interest-rate movements. Nevertheless, changes in interest rates can have negative effects on bank profitability and must be carefully managed, especially given the rapid pace of financial innovation and the heightened level of competition among all types of financial institutions.

## SOUND IRR MANAGEMENT PRACTICES

As is the case in managing other types of risk,

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2. For some instruments, economic values may be the same as fair value—especially when prices from active markets are available. The fair value of an instrument is generally considered to be the amount at which the instrument could be exchanged in a current transaction between willing parties other than in a forced or liquidation sale. Even then, the economic values of instruments and firms may differ from fair values due to unique insights on the intrinsic value of instruments derived on a going-concern basis.

sound IRR management involves effective board and senior management oversight and a comprehensive risk-management process that includes the following elements:

- effective policies and procedures designed to control the nature and amount of IRR, including clearly defined IRR limits and lines of responsibility and authority
- appropriate risk-measurement, monitoring, and reporting systems
- systematic internal controls that include the internal or external review and/or audit of key elements of the risk-management process

The formality and sophistication used in managing IRR depends on the size and sophistication of the institution, the nature and complexity of its holdings and activities, and the overall level of its IRR. Adequate IRR management practices can vary considerably. For example, a small institution with noncomplex activities and holdings, a relatively short-term balance-sheet structure presenting a low IRR profile, and senior managers and directors who are actively involved in the details of day-to-day operations may be able to rely on relatively simple and informal IRR management systems.

More complex institutions and those with higher interest-rate risk exposures or holdings of complex instruments may require more elaborate and formal IRR management systems to address their broader and typically more complex range of financial activities, as well as provide senior managers and directors with the information they need to monitor and direct day-to-day activities. The more complex interest-rate risk management processes often employed at these institutions may require more formal internal controls, such as internal and external audits, to ensure the integrity of the information senior officials use to oversee compliance with policies and limits.

Individuals involved in the risk-management process should be sufficiently independent of business lines to ensure adequate separation of duties and avoid potential conflicts of interest. The degree of autonomy these individuals have may be a function of the size and complexity of the institution. In smaller and less complex institutions with limited resources, it may not be possible to completely remove individuals with business-line responsibilities from the risk-management process. In these cases, focus should be directed towards ensuring that risk-

management functions are conducted effectively and objectively. Larger, more complex institutions may have separate and independent risk-management units.

## Board and Senior Management Oversight

Effective oversight by a bank's board of directors and senior management is critical to a sound IRR management process. The board and senior management should be aware of their responsibilities related to IRR management, understand the nature and level of interest-rate risk taken by the bank, and ensure that the formality and sophistication of the risk-management process is appropriate for the overall level of risk.

### *Board of Directors*

The board of directors has the ultimate responsibility for the level of IRR taken by the institution. The board should approve business strategies and significant policies that govern or influence the institution's interest-rate risk. It should articulate overall IRR objectives and should ensure the provision of clear guidance on the level of acceptable IRR.<sup>3</sup> The board should also approve policies and procedures that identify lines of authority and responsibility for managing IRR exposures.

Directors should understand the nature of the risks to their institution and ensure that management is identifying, measuring, monitoring, and controlling these risks. Accordingly, the board should monitor the performance and IRR profile of the institution and periodically review information that is timely and sufficiently detailed to allow directors to understand and assess the IRR facing the institution's key portfolios and the institution as a whole. The frequency of these reviews depends on the sophistication of the institution, the complexity of its holdings, and the materiality of changes in its holdings between reviews. Institutions holding significant positions in complex instruments or with significant changes in the composition of holdings would be expected to have more frequent reviews. In addition, the board should periodically review

3. For example, objectives for IRR could be set in terms of enhancement to income, liquidity, and value, while IRR limits could be expressed as acceptable levels of volatility in these same areas.

significant IRR management policies and procedures, as well as overall business strategies that affect the institution's IRR exposure.

The board of directors should encourage discussions between its members and senior management, as well as between senior management and others in the institution, regarding the institution's IRR exposures and management process. Board members need not have detailed technical knowledge of complex financial instruments, legal issues, or sophisticated risk-management techniques. However, they are responsible for ensuring that the institution has personnel available who have the necessary technical skills and that senior management fully understands the risks incurred by the institution and is sufficiently controlling them.

A bank's board of directors may meet its responsibilities in a variety of ways, including the identification of selected board members to become directly involved in risk-management activities by participating on board committees or by otherwise gaining a sufficient understanding and awareness of the institution's risk profile through periodic briefings and management reports. Information provided to board members should be presented in a format that members can readily understand and that will assist them in making informed policy decisions about acceptable levels of risk, the nature of risks in current and proposed new activities, and the adequacy of the institution's risk-management process. In short, regardless of the structure of the organization and the composition of its board of directors or delegated board committees, board members must ensure that the institution has the necessary technical skills and management expertise to conduct its activities prudently and consistently within the policies and intent of the board.

### *Senior Management*

Senior management is responsible for ensuring that the institution has adequate policies and procedures for managing IRR on both a long-range and day-to-day basis and that it maintains clear lines of authority and responsibility for managing and controlling this risk. Management should develop and implement policies and procedures that translate the board's goals, objectives, and risk limits into operating standards that are well understood by bank personnel and that are consistent with the board's

intent. Management is also responsible for maintaining (1) adequate systems and standards for measuring risk, (2) standards for valuing positions and measuring performance, (3) a comprehensive IRR reporting and monitoring process, and (4) effective internal controls and review processes.

IRR reports to senior management should provide aggregate information as well as sufficient supporting detail so that management can assess the sensitivity of the institution to changes in market conditions and other important risk factors. Senior management should also periodically review the organization's IRR management policies and procedures to ensure that they remain appropriate and sound. Senior management should also encourage and participate in discussions with members of the board and—when appropriate to the size and complexity of the institution—with risk-management staff regarding risk-measurement, reporting, and management procedures.

Management should ensure that analysis and risk-management activities related to IRR are conducted by competent staff whose technical knowledge and experience is consistent with the nature and scope of the institution's activities. The staff should have enough knowledgeable people to serve as backup to key personnel.

### *Policies, Procedures, and Limits*

Institutions should have clear policies and procedures for limiting and controlling IRR. These policies and procedures should (1) delineate lines of responsibility and accountability over IRR management decisions, (2) clearly define authorized instruments and permissible hedging and position taking strategies, (3) identify the frequency and method for measuring and monitoring IRR, and (4) specify quantitative limits that define the acceptable level of risk for the institution. In addition, management should define the specific procedures and approvals necessary for exceptions to policies, limits, and authorizations. All IRR risk policies should be reviewed periodically and revised as needed.

### *Clear Lines of Authority*

Whether through formal written policies or clear operating procedures, management should define

the structure of managerial responsibilities and oversight, including lines of authority and responsibility in the following areas:

- developing and implementing strategies and tactics used in managing IRR
- establishing and maintaining an IRR measurement and monitoring system
- identifying potential IRR and related issues arising from the potential use of new products
- developing IRR management policies, procedures and limits, and authorizing exceptions to policies and limits

Individuals and committees responsible for making decisions about interest-rate risk management should be clearly identified. Many medium-sized and large banks and banks with concentrations in complex instruments delegate responsibility for IRR management to a committee of senior managers, sometimes called an asset/liability committee (ALCO). In such institutions, policies should clearly identify ALCO membership, the committee's duties and responsibilities, the extent of its decision-making authority, and the form and frequency of its periodic reports to senior management and the board of directors. An ALCO should have sufficiently broad participation across major banking functions (for example, lending, investment, deposit, funding) to ensure that its decisions can be executed effectively throughout the institution. In many large institutions, the ALCO delegates day-to-day responsibilities for IRR management to an independent risk-management department or function.

Regardless of the level of organization and formality used to manage IRR, individuals involved in the risk-management process (including separate risk-management units, if present) should be sufficiently independent of the business lines to ensure adequate separation of duties and avoid potential conflicts of interest. Also, personnel charged with measuring and monitoring IRR should have a well-founded understanding of all aspects of the institution's IRR profile. Compensation policies for these individuals should be adequate enough to attract and retain personnel who are well qualified to assess the risks of the institution's activities.

### *Authorized Activities*

Institutions should clearly identify the types of

financial instruments that are permissible for managing IRR, either specifically or by their characteristics. As appropriate to its size and complexity, the institution should delineate procedures for acquiring specific instruments, managing individual portfolios, and controlling the institution's aggregate IRR exposure. Major hedging or risk-management initiatives should be approved by the board or its appropriate delegated committee before being implemented.

Before introducing new products, hedging, or position-taking initiatives, management should also ensure that adequate operational procedures and risk-control systems are in place. Proposals to undertake such new instruments or activities should contain these features:

- a description of the relevant product or activity
- an identification of the resources required to establish sound and effective IRR management of the product or activity
- an analysis of the risk of loss from the proposed activities in relation to the institution's overall financial condition and capital levels
- the procedures to be used to measure, monitor, and control the risks of the proposed product or activity

### *Limits*

The goal of IRR management is to maintain an institution's interest-rate risk exposure within self-imposed parameters over a range of possible changes in interest rates. A system of IRR limits and risk-taking guidelines provides the means for achieving that goal. Such a system should set boundaries for the institution's level of IRR and, where appropriate, provide the capability to allocate these limits to individual portfolios or activities. Limit systems should also ensure that limit violations receive prompt management attention.

Aggregate IRR limits clearly articulating the amount of IRR acceptable to the firm should be approved by the board of directors and reevaluated periodically. Limits should be appropriate to the size, complexity, and financial condition of the organization. Depending on the nature of an institution's holdings and its general sophistication, limits can also be identified for individual business units, portfolios, instrument

types, or specific instruments.<sup>4</sup> The level of detail of risk limits should reflect the characteristics of the institution's holdings, including the various sources of IRR to which the institution is exposed. Limits applied to portfolio categories and individual instruments should be consistent with and complementary to consolidated limits.

IRR limits should be consistent with the institution's overall approach to measuring and managing IRR and should address the potential impact of changes in market interest rates on both reported earnings and the institution's economic value of equity (EVE). From an earnings perspective, institutions should explore limits on net income as well as net interest income to fully assess the contribution of non-interest income to the IRR exposure of the institution. Limits addressing the effect of changing interest rates on economic value may range from those focusing on the potential volatility of the value of the institution's major holdings to a comprehensive estimate of the exposure of the institution's EVE.

The limits for addressing the effect of rates on an institution's profitability and EVE should be appropriate for the size and complexity of its underlying positions. Relatively simple limits identifying maximum maturity/repricing gaps, acceptable maturity profiles, or the extent of volatile holdings may be adequate for institutions engaged in traditional banking activities and with few holdings of long-term instruments, options, instruments with embedded options, or other instruments whose value may be substantially affected by changes in market rates. For more complex institutions, quantitative limits on acceptable changes in its estimated earnings and EVE under specified scenarios may be more appropriate. Banks that have significant intermediate- and long-term mismatches or complex option positions should, at a minimum, have economic value-oriented limits that quantify and constrain the potential changes in economic value or bank capital that could arise from those positions.

Limits on the IRR exposure of earnings should be broadly consistent with those used to control the exposure of a bank's economic value. IRR limits on earnings variability prima-

rily address the near-term recognition of the effects of changing interest rates on the institution's financial condition. IRR limits on economic value reflect efforts to control the effect of changes in market rates on the present value of the entire future earnings stream arising from the institution's current holdings.

IRR limits and risk tolerances may be keyed to specific scenarios of market-interest-rate movements, such as an increase or decrease of a particular magnitude. The rate movements used in developing these limits should represent meaningful stress situations, taking into account historic rate volatility and the time required for management to address exposures. Moreover, stress scenarios should take account of the range of the institution's IRR characteristics, including mismatch, basis, and option risks. Simple scenarios using parallel shifts in interest rates may be insufficient to identify these risks.

Increasingly, large, complex institutions are using advanced statistical techniques to measure IRR across a probability distribution of potential interest-rate movements and express limits in terms of statistical confidence intervals. If properly used, these techniques can be particularly useful in measuring and managing options positions.

## Risk-Measurement and -Monitoring Systems

An effective process of measuring, monitoring, and reporting exposures is essential for adequately managing IRR. The sophistication and complexity of this process should be appropriate to the size, complexity, nature, and mix of an institution's business lines and its IRR characteristics.

### *IRR Measurement*

Well-managed banks have IRR measurement systems that measure the effect of rate changes on both earnings and economic value. The latter is particularly important for institutions with significant holdings of intermediate and long-term instruments or instruments with embedded options because their market values can be particularly sensitive to changes in market interest rates. Institutions with significant non-interest income that is sensitive to changes in

4. Section 2020, "Acquisition and Management of Non-trading Securities and Derivative Products," discusses issues in setting price volatility limits in the acquisition of securities and derivatives.

interest rates should focus special attention on net income as well as net interest income. Since the value of instruments with intermediate and long maturities and embedded options is especially sensitive to interest-rate changes, banks with significant holdings of these instruments should be able to assess the potential longer-term impact of changes in interest rates on the value of these positions—the overall potential performance of the bank.

IRR measurement systems should (1) assess all material IRR associated with an institution's assets, liabilities, and OBS positions; (2) use generally accepted financial concepts and risk-measurement techniques; and (3) have well-documented assumptions and parameters. Material sources of IRR include the mismatch, basis, and option risk exposures of the institution. In many cases, the interest-rate characteristics of a bank's largest holdings will dominate its aggregate risk profile. While all of a bank's holdings should receive appropriate treatment, measurement systems should rigorously evaluate the major holdings and instruments whose values are especially sensitive to rate changes. Instruments with significant embedded or explicit option characteristics should receive special attention.

IRR measurement systems should use generally accepted financial measurement techniques and conventions to estimate the bank's exposure. Examiners should evaluate these systems in the context of the level of sophistication and complexity of the institution's holdings and activities. A number of accepted techniques are available for measuring the IRR exposure of both earnings and economic value. Their complexity ranges from simple calculations and static simulations using current holdings to highly sophisticated dynamic modeling techniques that reflect potential future business and business decisions. Basic IRR measurement techniques begin with a maturity/repricing schedule, which distributes assets, liabilities, and OBS holdings into time bands according to their final maturity (if fixed-rate) or time remaining to their next repricing (if floating). The choice of time bands may vary from bank to bank. Those assets and liabilities lacking contractual repricing intervals or maturities are assigned to repricing time bands according to the judgment and analysis of the institution.

Simple maturity/repricing schedules can be used to generate rough indicators of the IRR sensitivity of both earnings and economic values

to changing interest rates. To evaluate earnings exposures, liabilities arrayed in each time band can be subtracted from the assets arrayed in the same time band to yield a dollar amount of maturity/repricing mismatch or gap in each time band. The sign and magnitude of the gaps in various time bands can be used to assess potential earnings volatility arising from changes in market interest rates.

A maturity/repricing schedule can also be used to evaluate the effects of changing rates on an institution's economic value. At the most basic level, mismatches or gaps in long-dated time bands can provide insights into the potential vulnerability of the economic value of relatively noncomplex institutions. Such long-term gap calculations along with simple maturity distributions of holdings may be sufficient for relatively noncomplex institutions. On a slightly more advanced, yet still simplistic, level, estimates of the change in an institution's economic value can be calculated by applying economic-value sensitivity weights to the asset and liability positions slotted in the time bands of a maturity/repricing schedule. The weights can be constructed to represent estimates of the change in value of the instruments maturing or repricing in that time band given a specified interest-rate scenario. When these weights are applied to the institution's assets, liabilities, and OBS positions and subsequently netted, the result can provide a rough approximation of the change in the institution's EVE under the assumed scenario. These measurement techniques can prove especially useful for institutions with small holdings of complex instruments.<sup>5</sup> Further refinements to simple risk weighting techniques can be achieved by incorporating the risk of options, the potential for basis risk, and non-parallel shifts in the yield curve using customized risk weights applied to the specific instruments or instrument types arrayed in the maturity repricing schedule.

Larger institutions and those with complex risk profiles that entail meaningful basis or option risks may find it difficult to monitor IRR adequately using simple maturity/repricing analyses. Generally, they will need to employ more

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5. James V. Houpt and James A. Embersit, "A Method for Evaluating Interest Rate Risk in Commercial Banks," *Federal Reserve Bulletin*, vol. 77 (August 1991), 625-37 and David M. Wright and James V. Houpt, "An Analysis of Commercial Bank Exposure to Interest Rate Risk," *Federal Reserve Bulletin*, vol. 82 (February 1996), 115-128.



sophisticated simulation techniques. For assessing the exposure of earnings, simulations estimating cash flows and resulting earnings streams over a specific period are conducted based on existing holdings and assumed interest-rate scenarios. When these cash flows are simulated over the entire expected lives of the institution's holdings and discounted back to their present values, an estimate of the change in EVE can be calculated.

Static cash-flow simulations of current holdings can be made more dynamic by incorporating more detailed assumptions about the future course of interest rates and the expected changes in a bank's business activity over a specified time horizon. Combining assumptions on future activities and reinvestment strategies with information about current holdings, these simulations can project expected cash flows and estimate dynamic earnings and EVE outcomes. These more sophisticated techniques, such as option-adjusted pricing analysis and Monte Carlo simulation, allow for dynamic interaction of payment streams and interest rates to better capture the effect of embedded or explicit options.

The IRR measurement techniques and associated models should be sufficiently robust to adequately measure the risk profile of the institution's holdings. Depending on the size and sophistication of the institution and its activities, as well as the nature of its holdings, the IRR measurement system should have the capability to adequately reflect (1) uncertain principal amortization and prepayments; (2) caps and floors on loans and securities, where material; (3) the characteristics of both basic and complex OBS instruments held by the institution; and (4) changing spread relationships necessary to capture basis risk. Moreover, IRR models should provide clear reports that identify major assumptions and allow management to evaluate the reasonableness of and internal consistency among key assumptions.

### *Data Integrity and Assumptions*

The usefulness of IRR measures depends on the integrity of the data on current holdings, validity of the underlying assumptions, and IRR scenarios used to model IRR exposures. Techniques involving sophisticated simulations should be used carefully so that they do not become "black boxes," producing numbers that appear to be precise, but that may be less accurate when

their specific assumptions and parameters are revealed.

The integrity of data on current positions is an important component of the risk-measurement process. Institutions should ensure that current positions are delineated at an appropriate level of aggregation (for example, by instrument type, coupon rate, or repricing characteristic) to ensure that risk measures capture all meaningful types and sources of IRR, including those arising from explicit or embedded options. Management should also ensure that all material positions are represented in IRR measures, that the data used are accurate and meaningful, and that the data adequately reflect all relevant repricing and maturity characteristics. When applicable, data should include information on the contractual coupon rates and cash flows of associated instruments and contracts. Manual adjustments to underlying data should be well documented.

Senior management and risk managers should recognize the key assumptions used in IRR measurement, as well as reevaluate and approve them periodically. Assumptions should also be documented clearly and, ideally, the effect of alternative assumptions should be presented so that their significance can be fully understood. Assumptions used in assessing the interest-rate sensitivity of complex instruments, such as those with embedded options, and instruments with uncertain maturities, such as core deposits, should be subject to rigorous documentation and review, as appropriate to the size and sophistication of the institution. Assumptions about customer behavior and new business should take proper account of historical patterns and be consistent with the interest-rate scenarios used.

### *Nonmaturity Deposits*

An institution's IRR measurement system should consider the sensitivity of nonmaturity deposits, including demand deposits, NOW accounts, savings deposits, and money market deposit accounts. Nonmaturity deposits represent a large portion of the industry's funding base, and a variety of techniques are used to analyze their IRR characteristics. The use of these techniques should be appropriate to the size, sophistication, and complexity of the institution.

In general, treatment of nonmaturity deposits should consider the historical behavior of the institution's deposits; general conditions in the institution's markets, including the degree of

competition it faces; and anticipated pricing behavior under the scenario investigated. Assumptions should be supported to the fullest extent practicable. Treatment of nonmaturity deposits within the measurement system may, of course, change from time to time based on market and economic conditions. Such changes should be well founded and documented. Treatments used in constructing earnings simulation assessments should be conceptually and empirically consistent with those used in developing EVE assessments of IRR.

### IRR Scenarios

IRR exposure estimates, whether linked to earnings or economic value, use some form of forecasts or scenarios of possible changes in market interest rates. Bank management should ensure that IRR is measured over a probable range of potential interest-rate changes, including meaningful stress situations. The scenarios used should be large enough to expose all of the meaningful sources of IRR associated with an institution's holdings. In developing appropriate scenarios, bank management should consider the current level and term structure of rates and possible changes to that environment, given the historical and expected future volatility of market rates. At a minimum, scenarios should include an instantaneous plus or minus 200 basis point parallel shift in market rates.<sup>6</sup> Institutions

6. Analysis of quarterly and annual data on changes of the Constant Maturities Treasury Securities (CMT) over the period of January 1, 1974, to December 31, 1994, suggests that a 200 basis point parallel shift in the yield curve represents a plausible stress scenario for assessing IRR. The following data illustrate that over the past 17 years, quarterly changes in yields on CMTs exceeded 193 bp for the three-month CMT and 137 bp for the 30-year CMT 1 percent of the time. Data on annual yield changes illustrate that yield changes on CMTs exceeded 194 bp 5 percent of the time and exceeded 151 bp 10 percent of the time.

Changes in Yields of Constant Maturities Treasury Securities

	Quarterly changes		Annual changes	
	99% confidence level	95% confidence level	90% confidence level	
	Basis Point Change			
3-mo. CMT	193 bp	274 bp	212 bp	
1-yr. CMT	191 bp	271 bp	210 bp	
2-yr. CMT	180 bp	255 bp	198 bp	
3-yr. CMT	175 bp	248 bp	192 bp	
5-yr. CMT	166 bp	235 bp	182 bp	
7-yr. CMT	161 bp	228 bp	177 bp	
10-yr. CMT	152 bp	216 bp	167 bp	
30-yr. CMT	137 bp	194 bp	151 bp	

should also consider the use of multiple scenarios, including the potential effects of changes in the relationships among interest rates (option risk and basis risk) as well as changes in the general level of interest rates and changes in the shape of the yield curve.

The risk-measurement system should support a meaningful evaluation of the effect of stressful market conditions on the institution. Stress-testing should be designed to provide information on the kinds of conditions under which the institution's strategies or positions would be most vulnerable; thus, testing may be tailored to the risk characteristics of the institution. Possible stress scenarios might include abrupt changes in the term structure of interest rates, relationships among key market rates (basis risk), liquidity of key financial markets, or volatility of market rates. In addition, stress scenarios should include conditions under which key business assumptions and parameters break down. The stress-testing of assumptions used for illiquid instruments and instruments with uncertain contractual maturities, such as core deposits, is particularly critical to achieving an understanding of the institution's risk profile. Therefore, stress scenarios may not only include extremes of observed market conditions but also plausible worst-case scenarios.

Management and the board of directors should periodically review the results of stress tests and the appropriateness of key underlying assumptions. Stress-testing should be supported by appropriate contingency plans.

### IRR Monitoring and Reporting

An accurate, informative, and timely management information system is essential for managing IRR exposure, both to inform management and support compliance with board policy. Reporting of risk measures should be regular and clearly compare current exposure with policy limits. In addition, past forecasts or risk estimates should be compared with actual results as one tool to identify any potential shortcomings in modeling techniques.

A bank's senior management and its board or a board committee should receive reports on the bank's IRR profile at least quarterly. More frequent reporting may be appropriate depending on the bank's level of risk and its potential for significant change. While the types of reports prepared for the board and for various levels of

management will vary based on the institution's IRR profile, they should, at a minimum, allow senior management and the board or committee to—

- evaluate the level of and trends in the bank's aggregate IRR exposure;
- demonstrate and verify compliance with all policies and limits;
- evaluate the sensitivity and reasonableness of key assumptions;
- assess the results and future implications of major hedging or position-taking initiatives that have been taken or are being actively considered;
- understand the implications of various stress scenarios, including those involving break-downs of key assumptions and parameters;
- review IRR policies, procedures, and the adequacy of the IRR measurement systems; and
- determine whether the bank holds sufficient capital for the level of risk being taken.

## Comprehensive Internal Controls

An institution's IRR management process should be an extension of its overall structure of internal controls. Properly structured, a system of internal controls should promote effective and efficient operations; reliable financial and regulatory reporting; and compliance with relevant laws, regulations, and institutional policies. In determining whether internal controls meet these objectives, examiners should consider the general control environment of the organization; the process for identifying, analyzing, and managing IRR; the adequacy of management information systems; and adherence to control activities such as approvals, confirmations, and reconciliations.

An important element of an institution's internal controls for IRR is management's comprehensive evaluation and review of the various components of the IRR management process. Although procedures for establishing limits and adhering to them may vary among institutions, periodic reviews should be conducted to determine whether the organization enforces its IRR policies and procedures. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to the process described

in approved policies. Periodic reviews of the IRR management process should also be conducted in light of significant changes in the nature of instruments acquired, risk-measurement methodologies, limits, and internal controls that have occurred since the last review.

Reviews of the accuracy and performance of the IRR measurement system should also be conducted and include assessments of the assumptions, parameters, and methodologies used in the institution's IRR measurement system. During a review, examiners should seek to understand, test, and document the current measurement process; evaluate the system's accuracy; and recommend solutions to any identified weaknesses. The results of this review, along with any recommendations for improvement, should be reported to the board and acted upon in a timely manner. Institutions with complex risk exposure are encouraged to have their measurement systems reviewed by external auditors or other knowledgeable outside parties to ensure their adequacy and integrity. Since measurement systems may incorporate one or more subsidiary systems or processes, institutions should ensure that multiple component systems are well integrated and consistent in all critical respects.

The frequency and extent to which an institution should reevaluate its risk-measurement methodologies and models depends, in part, on the specific IRR exposures created by their holdings and activities, the pace and nature of changes in market interest rates, and the extent to which there are new developments in measuring and managing IRR. At a minimum, institutions should review their underlying IRR measurement methodologies and IRR management process annually, and more frequently as market conditions dictate. In many cases, internal evaluations may be supplemented by reviews of external auditors or other qualified outside parties, such as consultants with expertise in IRR management.

## Rating the Adequacy of IRR Management

Examiners should incorporate their assessment of the adequacy of IRR management into their overall rating of risk management, which is subsequently factored into the management component of an institution's CAMELS rating. Rat-

ings of IRR management can follow the general framework used to rate overall risk management:

- A rating of 1 or strong would indicate that management effectively identifies and controls the IRR posed by the institution's activities, including those from new products.
- A rating of 2 or satisfactory would indicate that the institution's management of IRR is largely effective, but lacking in some modest degree. It reflects a responsiveness and ability to cope successfully with existing and foreseeable exposures that may arise in carrying out the institution's business plan. While the institution may have some minor risk-management weaknesses, these problems have been recognized and are being addressed. Generally, risks are being controlled in a manner that does not require additional or more than normal supervisory attention.
- A rating of 3 or fair signifies IRR management practices that are lacking in some important ways and, therefore, are a cause for more than normal supervisory attention. One or more of the four elements of sound IRR management are considered fair and have precluded the institution from fully addressing a significant risk to its operations. Certain risk-management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and control adequately all significant risks to the institution.
- A rating of 4 or marginal represents marginal IRR management practices that generally fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management are considered marginal and require immediate and concerted corrective action by the board and management.
- A rating of 5 or unsatisfactory indicates a critical absence of effective risk-management practices to identify, monitor, or control significant risk exposures. One or more of the four elements of sound risk management is considered wholly deficient, and management and the board have not demonstrated the capability to address deficiencies. Deficiencies in the institution's risk-management procedures and internal controls require immediate and close supervisory attention.

## QUANTITATIVE LEVEL OF IRR EXPOSURE

Evaluating the quantitative level of IRR involves assessing the effects of both past and potential future changes in interest rates on an institution's financial condition, including the effects on its earnings, capital adequacy, liquidity, and, in some cases, asset quality. This assessment involves a broad analysis of an institution's business mix, balance-sheet composition, OBS holdings, and holdings of interest rate-sensitive instruments. Characteristics of the institution's material holdings should also be investigated to determine (and quantify) how changes in interest rates might affect its performance. The rigor of this evaluation process should reflect the size, sophistication, and nature of the institution's holdings.

### Assessment of the Composition of Holdings

An overall evaluation of an institution's holdings and its business mix is an important first step in evaluating the quantitative level of IRR exposure. The evaluation should focus on identifying (1) major on- and off-balance-sheet positions, (2) concentrations in interest-sensitive instruments, (3) the existence of highly volatile instruments, and (4) significant sources of non-interest income that may be sensitive to changes in interest rates. Identifying major holdings of particular types or classes of assets, liabilities, or off-balance-sheet instruments is particularly pertinent since the interest rate-sensitivity characteristics of an institution's largest positions or activities will tend to dominate its IRR profile. The composition of assets should be assessed to determine the types of instruments held and the relative proportion of holdings they represent, both with respect to total assets and within appropriate instrument portfolios. Examiners should note any specialization or concentration in particular types of investment securities or lending activities and identify the interest-rate characteristics of the instruments or activities. The assessment should also incorporate an evaluation of funding strategies and the composition of deposits, including core deposits. Trends and changes in the composition of assets, liabilities, and off-balance-sheet holdings should be fully assessed—especially

when the institution is experiencing significant growth.

Examiners should identify the interest sensitivity of an institution's major holdings. For many instruments, the stated final maturity, coupon interest payment, and repricing frequency are the primary determinants of their interest-rate sensitivity. In general, the shorter the repricing frequency, or maturity for fixed-rate instruments, the greater the impact of a change in rates on the *earnings* of the asset, liability, or OBS instrument employed will be because the cash flows derived, either through repricing or reinvestment, will more quickly reflect market rates. Conversely, the longer the repricing frequency, or maturity for fixed-rate instruments, the more sensitive the *value* of the instrument will be to changes in market interest rates. Accordingly, basic maturity/repricing distributions and gap schedules are important first screens in identifying the interest sensitivity of major holdings from both an earnings and value standpoint.

Efforts should also be made to identify instruments whose value is highly sensitive to rate changes. Even if they do not represent a major position, the rate sensitivity of these holdings may be large enough to have a material effect on the institution's aggregate exposure. Highly interest rate-sensitive instruments generally have fixed-rate coupons with long maturities, significant embedded options, or some elements of both. Identifying explicit options and instruments with embedded options is particularly important. Because of their asymmetrical cash flows under varying scenarios, these holdings may exhibit significantly volatile price and earnings behavior in changing-rate environments. The interest-rate sensitivity of exchange-traded options is usually readily identified due to the standardization of exchange contracts. On the other hand, the interest-rate sensitivity of over-the-counter derivative instruments and the option provisions embedded in other financial instruments, such as the right to prepay a loan without penalty, may be less readily identifiable. Instruments tied to residential mortgages, such as mortgage pass-through securities, collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), and various mortgage-derivative products, generally entail some form of embedded optionality. Certain types of CMOs and REMICs constitute high-risk mortgage-derivative products and should be clearly identified. U.S. agency and

municipal securities, as well as traditional forms of lending and borrowing arrangements, can often incorporate options into their structures. U.S. agency structured notes and municipal securities with long-dated call provisions are just two examples. Many commercial loans also make use of caps or floors. Over-the-counter OBS instruments, such as swaps, caps, floors, and collars, can involve highly complex structures and, thus, can be quite volatile in the face of changing interest rates.

An evaluation of an institution's funding sources relative to the profile of its assets is fundamental to the assessment of IRR. Reliance on volatile or complex funding structures can significantly increase IRR when asset structures are fixed-rate or long-term in nature. Conversely, long-term liabilities financing shorter-term assets can also increase IRR. The role of nonmaturity or core deposits in an institution's funding base is particularly pertinent to any assessment of IRR. Depending on their composition and the underlying client base, core deposits can provide significant opportunities for institutions to administer and manage the interest rates paid on this funding source. Thus, high levels of stable core deposit funding may provide an institution with significant control over its IRR profile. Examiners should assess the characteristics of an institution's nonmaturity deposit base, including the types of accounts offered, the underlying customer base, and important trends that may influence the rate sensitivity of this funding source.

In general, examiners should evaluate trends and attempt to identify any structural changes in the interest-rate risk profile of an institution's holdings, such as shifts of asset holdings into longer-term instruments or instruments that may have embedded options, changes in funding strategies and core deposit balances, and the use of off-balance-sheet instruments. Significant changes in the composition of an institution's holdings may reduce the usefulness of historical performance as an indicator of future performance.

Examiners should also identify and assess material sources of interest-sensitive fee income. Loan-servicing income, especially when related to residential mortgages, can be an important and highly volatile element in an institution's earnings profile. Servicing income is linked to the size of the servicing portfolio and, thus, can be greatly affected by the rate of prepayment on mortgages in the servicing portfolio. Revenues

arising from securitization of other types of loans, including credit card receivables, can also be very sensitive to changes in interest rates.

An analysis of both on- and off-balance-sheet holdings should also consider potential basis risk, that is, whether instruments with adjustable-rate characteristics that reprice in a similar time period will reprice differently than assumed. Consideration of basis risk is particularly pertinent when offsetting positions reprice in the same time period. Typical examples include assets that reprice with three-month Treasury bills paired against liabilities repricing with three-month LIBOR or prime-based assets paired against other short-term funding sources. Analyzing the repricing characteristics of major adjustable-rate positions should help to identify such situations.

## Exposure of Earnings to IRR

When evaluating the potential effects of changing rates on an institution's earnings, examiners should assess the key determinants of the net interest margin, the effect that fluctuations in net interest margins can have on overall net income, and the rate sensitivity of non-interest income and expense. Analyzing the historical behavior of the net interest margin, including the yields on major assets, liabilities, and off-balance-sheet positions that make up that margin, can provide useful insights into the relative stability of an institution's earnings. For example, a review of the historical composition of assets and the yields earned on those assets clearly identifies an institution's business mix and revenue-generating strategies and reveals important insights into the potential vulnerabilities of these revenues to changes in rates. Similarly, an assessment of the rates paid on various types of deposits over time can help identify the institution's funding strategies, how the institution competes for deposits, and the potential vulnerability of its funding base to rate changes.

Understanding the effect of potential fluctuations in net interest income on overall operating performance is also important. High overhead structures at some banks may require high net interest margins to generate even moderate levels of income. Accordingly, relatively high net interest margins may not necessarily imply a higher tolerance to changes in interest rates.

Examiners should fully consider the potential effects of fluctuating net interest margins when analyzing the exposure of net income to changes in interest rates.

Additionally, examiners should assess the contribution of non-interest income to net income, including its interest-rate sensitivity and how it affects the IRR of the institution. Significant sources of rate-insensitive non-interest income provide stability to net income and can mitigate the effect of fluctuations in net interest margins.

A historical review of changes in an institution's earnings—both net income and net interest income—in relation to changes in market rates is an important step in assessing the rate sensitivity of its earnings. When appropriate, this review should assess the institution's performance during prior periods of volatile rates.

Important tools used to gauge the potential volatility in future earnings include basic maturity and repricing gap calculations and income simulations. Short-term repricing gaps between assets and liabilities in intervals of one year or less can provide useful insights on the exposure of earnings. These can be used to develop rough approximations of the effect of changes in market rates on an institution's profitability. Examiners can develop rough gap estimates using available call report information, as well as the bank's own internally generated gap or other earnings exposure calculations if risk-management and -measurement systems are deemed adequate. When available, a bank's own earnings-simulation model provides a particularly valuable source of information: a formal estimate of future earnings (a "baseline") and an evaluation of how earnings would change under different rate scenarios. Together with historical earnings patterns, an institution's estimate of the IRR sensitivity of its earnings derived from simulation models is an important indication of the exposure of its near-term earnings stability.

As detailed in the preceding subsection, sound risk-management practices require IRR to be measured over a probable range of potential interest-rate changes. At a minimum, an instantaneous shift in the yield curve of plus or minus 200 basis points should be used to assess the potential impact of rate changes on an institution's earnings.

Examiners should evaluate the exposure of earnings to changes in interest rates relative to the institution's overall level of earnings and the potential length of time such exposure might

persist. For example, simulation estimates of a small, temporary decline in earnings, while likely an issue for shareholders and directors, may be less of a supervisory concern if the institution has a sound earnings and capital base. On the other hand, exposures that could offset earnings for a significant period (as some thrifts experienced during the 1980s) and even deplete capital would be a great concern to both management and supervisors. Exposures measured by gap or simulation analysis under the minimum 200 basis point scenario that would result in a significant decline in net interest margins or net income should prompt further investigation of the adequacy and stability of earnings and the adequacy of the institution's risk-management process. Specifically, in institutions exhibiting significant earnings exposures, examiners should emphasize the results of the institution's stress tests to determine the extent to which more significant and stressful rate moves might magnify the erosion in earnings identified in the more modest rate scenario. In addition, examiners should emphasize the need for management to understand the magnitude and nature of the institution's IRR and the adequacy of its limits.

While an erosion in net interest margins or net income of more than 25 percent under a 200 basis point scenario should warrant considerable examiner attention, examiners should take into account the absolute level of an institution's earnings both before and after the estimated IRR shock. For example, a 33 percent decline in earnings for a bank with a strong return on assets (ROA) of 1.50 percent would still leave the bank with an ROA of 1.00 percent. In contrast, the same percentage decline in earnings for a bank with a fair ROA of 0.75 percent results in a marginal ROA of 0.50 percent.

Examiners should ensure that their evaluation of the IRR exposure of earnings is incorporated into the rating of earnings under the CAMELS rating system. Institutions receiving an earnings rating of 1 or 2 would typically have minimal exposure to changing interest rates. Conversely, significant exposure of earnings to changes in rates may, in itself, provide a sufficient basis for a lower rating.

## Exposure of Capital and Economic Value

As set forth in the capital adequacy guidelines

for state member banks, the risk-based capital ratio focuses principally on broad categories of credit risk and does not incorporate other factors, including overall interest-rate exposure and management's ability to monitor and control financial and operating risks. Therefore, the guidelines point out that in addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of ". . . a bank's exposure to declines in economic value of its capital due to changes in interest rates. For this reason, the final supervisory judgement on a bank's capital adequacy may differ significantly from conclusions that might be drawn solely from the level of its risk-based capital ratio."

Banking organizations with low proportions of assets maturing or repricing beyond five years, relatively few assets with volatile market values (such as high-risk CMOs and structured notes or certain off-balance-sheet derivatives), and large and stable sources of nonmaturity deposits are unlikely to face significant economic value exposure. Consequently, an evaluation of their economic value exposure may be limited to reviewing available internal reports showing the asset/liability composition of the institution or the results of internal-gap, earnings-simulation, or economic-value simulation models to confirm that conclusion.

Institutions with fairly significant holdings of longer maturing or repricing assets, concentrations in value-sensitive on- and off-balance-sheet instruments, or a weak base of nonmaturity deposits warrant more formal and quantitative evaluations of economic-value exposures. This includes reviewing the results of the bank's own internal reports for measuring changes in economic value, which should address the adequacy of the institution's risk-management process, reliability of risk-measurement assumptions, integrity of the data, and comprehensiveness of any modeling procedures.

For institutions that appear to have a potentially significant level of IRR and that lack a reliable internal economic-value model, examiners should consider alternative means for quantifying economic-value exposure, such as internal-gap measures or off-site monitoring or surveillance screens that rely on call report data to estimate economic-value exposure. For example, the institution's gap schedules might be used to derive a duration gap by applying duration-based risk weights to the bank's aggregate positions. In estimating changes in economic value using alternative means, the relative

crudeness of these techniques and lack of detailed data (such as the absence of coupon or off-balance-sheet data) should be taken into account when drawing conclusions about the institution's exposure and capital adequacy.

An evaluation of an institution's capital adequacy should also consider the extent to which past interest-rate moves may have reduced the economic value of capital through the accumulation of net unrealized losses on financial instruments. To the extent that past rate moves have reduced the economic or market value of a bank's claims more than they have reduced the value of its obligations, the institution's economic value of capital is less than its stated book value.

To evaluate the embedded net loss or gain in an institution's financial structure, fair-value data on the securities portfolio can be used as the starting point; this information should be readily available from the call report or bank internal reports. Other major asset categories that might contain material embedded gains or losses include any assets maturing or repricing in more than five years, such as residential, multifamily, or commercial mortgage loans. By comparing a portfolio's weighted average coupon with current market yields, examiners may get an indication of the magnitude of any potential unrealized gains or losses. For companies with hedging strategies that use derivatives, the current positive or negative market value of these positions should be obtained, if available. For banks with material holdings of originated or purchased mortgage-servicing rights, capitalized amounts should be evaluated to ascertain that they are recorded at the lower of cost or fair value and that management has appropriately written down any values that are impaired pursuant to generally accepted accounting rules.

The presence of significant depreciation in securities, loans, or other assets does not necessarily indicate significant embedded net losses; depreciation may be offset by a decline in the market value of a bank's liabilities. For example, stable, low-cost nonmaturity deposits typically become more profitable to banks as rates rise, and they can add significantly to the bank's financial strength. Similarly, below-market-rate deposits, other borrowings, and subordinated debt may also offset unrealized asset losses caused by past rate hikes.

For banks with substantial depreciation in their securities portfolios, low levels of nonmaturity deposits and retail time deposits, or high

levels of IRR exposure, unrealized losses can have important implications for the supervisory assessment of capital adequacy. If stressful conditions require the liquidation or restructuring of the securities portfolio, economic losses could be realized and, thereby, reduce the institution's regulatory capitalization. Therefore, for higher-risk institutions, an evaluation of capital adequacy should consider the potential after-tax effect of the liquidation of available-for-sale and held-to-maturity accounts. Estimates of the effect of securities losses on regulatory capital ratio may be obtained from surveillance screens that use call report data or the bank's internal reports.

Examiners should also consider the potential effect of declines and fluctuations in earnings on an institution's capital adequacy. Using the results of internal model simulations or gap reports, examiners should determine whether capital-impairing losses might result from changes in market interest rates. In cases where potential rate changes are estimated to cause declines in margins that actually result in losses, examiners should assess the effect on capital over a two- or three-year earnings horizon.

When rating capital adequacy in the context of IRR exposure, examiners should consider the effect of changes in market interest rates on the economic value of equity, level of embedded losses in the bank's financial structure, and impact of potential rate changes on the institution's earnings. The IRR of institutions that show material declines in earnings or economic value of capital from a 200 basis point shift should be evaluated fully, especially if that decline would lower an institution's pro forma prompt-corrective-action category. For example, a well-capitalized institution with a 5.5 percent leverage ratio and an estimated change in economic value arising from an appropriate stress scenario amounting to 2.0 percent of assets would have an adjusted leverage ratio of 3.5 percent, causing a pro forma two-tier decline in its prompt-corrective-action category to the undercapitalized category. After considering the level of embedded losses in the balance sheet, the stability of the institution's funding base, its exposure to near-term losses, and the quality of its risk-management process, the examiner may need to give the institution's capital adequacy a relatively low rating. In general, sufficiently adverse effects of market-rate shocks or weak management and control procedures can provide a basis for lowering a bank's rating of capital adequacy. Moreover,



even less severe exposures could contribute to a lower rating if combined with exposures from asset concentrations, weak operating controls, or other areas of concern.

## Examination Process for Evaluating IRR

As the primary market risk most banks face, IRR should usually receive consideration in full-scope exams. It may also be the topic of targeted examinations. To meet examination objectives efficiently and effectively while remaining sensitive to potential burdens imposed on institutions, the examination of IRR should follow a structured, *risk-focused approach*. Key elements of a risk-focused approach to the examination process for IRR include (1) off-site monitoring and risk assessment of an institution's IRR profile and (2) appropriate planning and scoping of the on-site examination to ensure that it is as efficient and productive as possible. A fundamental tenet of this approach is that supervisory resources are targeted at functions, activities, and holdings that pose the most risk to the safety and soundness of an institution. Accordingly, institutions with low levels of IRR would be expected to receive relatively less supervisory attention than those with more severe IRR exposures.

Many banks have become especially skilled in managing and limiting the exposure of their earnings to changes in interest rates. Accordingly, for most banks and especially for smaller institutions with less complex holdings, the IRR element of the examination may be relatively simple and straightforward. On the other hand, some banks consider IRR an intended consequence of their business strategies and choose to take and manage that risk explicitly—often with complex financial instruments. These banks, along with banks that have a wide array of activities or complex holdings, generally should receive greater supervisory attention.

## Off-Site Risk Assessment

Off-site monitoring and analysis involves developing a preliminary view or “risk assessment” before initiating an on-site examination. Both the level of IRR exposure and quality of IRR management should be assessed to the

fullest extent possible during the off-site phase of the examination process. The following information can be helpful in this assessment:

- organizational charts and policies identifying authorities and responsibilities for managing IRR
- IRR policies, procedures, and limits
- ALCO committee minutes and reports (from six to twelve months before the examination)
- board of director reports on IRR exposures
- audit reports (both internal and external)
- position reports, including those for investment securities and off-balance-sheet instruments
- other available bank-internal-risk reports, including those detailing key assumptions
- reports outlining key characteristics of concentrations and material holdings of interest-sensitive instruments
- documentation for inputs, assumptions, and methodologies used in measuring risk
- Federal Reserve surveillance reports and supervisory screens

Quantitative IRR exposure can be assessed off-site by conducting as much of the analysis summarized in this subsection as is practicable. This includes assessments of the bank's overall balance-sheet composition and holdings of interest-sensitive instruments. An assessment of the exposure of earnings can be accomplished using supervisory screens, examiner-constructed measures, and internal bank measures obtained from management reports received before the on-site engagement. Similar assessments can be made on the exposure of capital or economic value.

An off-site review of the quality of the risk-management process can significantly improve the efficiency of the on-site engagement. The key to assessing the quality of management is an organized discovery process aimed at determining whether appropriate policies, procedures, limits, reporting systems, and internal controls are in place. This discovery process should, in particular, ascertain whether all the elements of a sound IRR management policy are applied consistently to material concentrations of interest-sensitive instruments. The results and reports of prior examinations provide important information about the adequacy of risk management.

## Examination Scope

The off-site risk assessment is an informed hypothesis of both the adequacy of IRR management and the magnitude of the institution's exposure. The scope of the on-site examination of IRR should be designed to confirm or reject that hypothesis and should target specific areas of interest or concern. In this way, examination procedures are tailored to the activities and risk profile of the institution and use flexible and targeted work-documentation programs for the on-site examination. Confirmation of hypotheses on the adequacy of the IRR management process is especially important. In general, if IRR management is identified as adequate, examiners can rely more heavily on the bank's internal IRR measures for assessing quantitative exposures.

The examination scope for assessing IRR should be commensurate with the complexity of the institution and consistent with the off-site risk assessment. For example, only baseline examination procedures would be used for institutions whose off-site risk assessment indicates that they have adequate IRR management processes and low levels of quantitative exposure. Such institutions would include those with noncomplex balance-sheet structures that meet the following criteria:

- Asset structures are principally short-term. Long-term assets constitute less than 25 percent of total assets and the combination of long-term assets and 30 percent of intermediate-term assets constitute less than 30 percent of assets. Long-term assets are considered those that have maturity or repricing intervals greater than five years, and intermediate-term assets are defined as those that have maturity or repricing intervals between one and five years.
- High-risk mortgage securities are less than 5 percent of total assets.
- Structured notes are less than 5 percent of total assets.
- There are no off-balance-sheet positions.
- The capital base is strong, and the institution has a history of stable earnings.

For these and other institutions identified as potentially low risk, the scope of the on-site examination would consist of only those examination procedures necessary to confirm the risk-assessment hypothesis. The adequacy of IRR

management could be confirmed through a basic review of the appropriateness of policies, internal reports, and controls and the institution's adherence to them. The integrity and reliability of the information used to assess the quantitative level of risk could be confirmed through limited sampling and testing. In general, if the risk assessment is confirmed by basic examination procedures, the examiner may conclude the IRR examination process.

Institutions assessed to have high levels of IRR exposure and strong IRR management may require more extensive examination scopes to confirm the risk assessment. These procedures may entail more analysis of the institution's IRR measurement system and the IRR characteristics of major holdings. Where high quantitative levels of exposure are found, examiners should focus special attention on the sources of this risk and on significant concentrations of interest-sensitive instruments. Institutions assessed to have high exposure and weak risk-management systems would require an extensive work-documentation program. Internal measures should be used cautiously, if at all.

Regardless of the size or complexity of an institution, care must be taken during the on-site phase of the examination to ensure confirmation of the risk assessment and identification of issues that may have escaped off-site analysis. Accordingly, the examination scope should be adjusted as on-site findings dictate.

## Assessing CAMELS Ratings

For most institutions, interest-rate risk is their primary market-risk exposure. Accordingly, the CAMELS market-risk sensitivity or "S" rating for these institutions should be based on assessments of the adequacy of IRR management practices and the quantitative level of IRR exposure.<sup>7</sup> In particular, CAMELS "S" ratings dealing primarily with IRR should be based on, but not limited to, an assessment of the following evaluation factors:

- the sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates

7. Section A.5020.1, "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System," provides guidance on the market-risk sensitivity component of the CAMELS rating system.

- the ability of management to identify, measure, monitor, and control exposure to interest-rate risk given the institution's size, complexity, and risk profile
- the nature and complexity of interest-rate risk exposure arising from nontrading positions
- where appropriate, the nature and complexity of market-risk exposure arising from trading and foreign operations

“S” ratings based primarily on IRR should conform with the following framework:

- 1 A rating of 1 indicates that interest-rate risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk-management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of interest-rate risk taken by the institution.
- 2 A rating of 2 indicates that interest-rate risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk-management practices are satisfactory for the size, sophistication, and interest-rate risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of interest-rate risk taken by the institution.
- 3 A rating of 3 indicates that control of interest-rate risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk-management practices need to be improved given the size, sophistication, and level of risk accepted by the institution. The level of earnings and capital may not adequately support the degree of interest-rate risk taken by the institution.
- 4 A rating of 4 indicates that control of interest-rate risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk-management practices are deficient for the size, sophistication, and level of risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of interest-rate risk taken by the institution.
- 5 A rating of 5 indicates that control of interest-rate risk sensitivity is unacceptable or that the level of risk taken by the institution is an imminent threat to its viability. Risk-management practices are wholly inadequate for the size, sophistication, and level of interest-rate risk accepted by the institution.

The adequacy of an institution's IRR management is a leading indicator of its potential IRR exposure. Therefore, assessment of IRR management practices should be the basis for the overall assessment of an institution's IRR. Unsafe exposures and management weaknesses should be fully reflected in “S” ratings. Unsafe exposures and unsound management practices that are not resolved during the on-site examination should be addressed through subsequent follow-up actions by the examiner and other supervisory personnel.

# Interest-Rate Risk Management

## Examination Objectives

Effective date November 1996

## Section 4090.2

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1. To evaluate the policies regarding interest-rate risk established by the board of directors and/or senior management, including the limits established for the bank's interest-rate risk profile.
2. To determine if the bank's interest-rate risk profile is within those limits.
3. To evaluate the management of the bank's interest-rate risk, including the adequacy of the methods and assumptions used to measure interest-rate risk.
4. To determine if internal management reporting systems provide the information necessary for informed interest-rate management decisions and for monitoring the results of those decisions.
5. To initiate corrective action when interest-rate management policies, practices, and/or procedures are deficient in controlling and monitoring interest-rate risk.

# Interest-Rate-Risk Management Examination Procedures

Effective date October 2008

## Section 4090.3

1. Determine if interest-rate risk is managed at the bank level or on a holding company basis.
2. Review the bank's written policies for reasonableness. At a minimum, they should cover—
  - a. definition and measurement of acceptable risks, including acceptable levels of interest-rate exposure;
  - b. net interest margin goals;
  - c. sources and uses of funds;
  - d. off-balance-sheet activities that affect interest-rate exposure;
  - e. responsibilities within the bank for interest-rate-risk management decisions; and
  - f. reporting mechanisms.
3. Evaluate the internal controls or the internal audit function. Determine whether internal mechanisms are adequate to ensure compliance with established limits on interest-rate risk. If they are determined to be inadequate, complete or update the Internal Control Questionnaire. The examiner should prepare a brief description of the bank's interest-rate-risk policies and practices as well as identify areas in need of improvement.
4. Review the UBPR, interim financial reports, and internal management reports, paying particular attention to—
  - a. on- and off-balance-sheet mix and trends;
  - b. the methodology used by the bank to measure interest-rate risk; and
  - c. the stability of interest margins under varying economic conditions or simulations (causes of significant fluctuations should be identified).
5. Evaluate the bank's exposure to interest-rate risk by:
  - a. Obtaining and reviewing any reports regularly prepared by management for controlling and monitoring interest-rate risk.
  - b. Requesting the appropriate information for determining the level of interest-rate risk present in the bank's assets, liabilities, and off-balance-sheet activities, if management does not, at a minimum, regularly prepare rate-sensitivity reports (the circumstances facing the bank and the existing interest-rate environment should govern the degree of analysis).
6. Evaluate the quality of interest-rate-risk management. The bank's procedures and controls should be in compliance with the minimum guidelines set forth in SR-96-13. See Section 4090.1 and SR-99-18. The evaluation should include, but is not limited to, the following:
  - a. Assess whether the methods and assumptions used to measure interest-rate risk are adequate relative to the size of the bank and the complexity of its balance sheet.
  - b. Assess management's knowledge of interest-rate risk in relation to the size and complexity of the bank's balance sheet. In particular, assess their understanding of the methods used by the bank to measure the risk.
  - c. Determine whether the level of risk is within the limits set.
  - d. Assess the bank's ability to adjust its interest-rate position.
  - e. Determine if the reporting process provides clear and reliable information on a timely basis (at least quarterly).
  - f. Determine if new products or hedging instruments are adequately analyzed before purchase.
7. Determine the adequacy of the net interest margin based on an analysis of the components of the margin (i.e., interest expense and interest income). If the margin or any component is unusually high or low, determine—
  - a. if goals have been established for net interest earnings;
  - b. management's success in meeting established goals;
  - c. the effect of the bank's interest-rate-risk position on meeting established goals;

- d. the effect of the bank's pricing policies on meeting established goals; and
  - e. the effect of the bank's credit-risk appetite on the margin.
8. Review the interest-rate-risk management section of the last report of examination. Determine if there were concerns in this area and if corrective action was required.
9. Write in appropriate report format and discuss with management general remarks on—
- a. the quality of the bank's planning to control and manage interest-rate risk;
- b. the level of the bank's interest-rate exposure and an assessment of the associated degree of risk;
  - c. the quality of the related administrative controls and internal management reporting systems; and
  - d. the effect of interest-rate-risk management decisions on earnings and capital.
10. Update the workpapers with any information that will facilitate future examinations.

# Interest Rate Risk Management Internal Control Questionnaire

Effective date May 1993

Section 4090.4

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Discuss with senior management the bank's policies and practices with regard to the following:

1. Has the board of directors, consistent with its duties and responsibilities, adopted an interest rate risk management policy that includes:
  - a. A formal mechanism to coordinate interest rate sensitivity decisions?
  - b. Clear lines of responsibility and authority for decisions affecting interest rate sensitivity?
  - c. Guidelines for the level of interest rate risk, including that associated with off-balance-sheet products, if any?
  - d. Outside limits for the imbalance between balance-sheet and off-balance-sheet positions and for the potential exposure of earnings or equity to changes in interest rates?
2. Have internal management reports been prepared that provide an adequate basis for

making interest rate management decisions and for monitoring the results of those decisions? Specifically:

- a. Are reports prepared on the bank's rate sensitivity using an appropriate measurement method?
  - b. Is historical information on asset yields, cost of funds, and net interest margins readily available?
  - c. Are interest margin variations, both from the prior reporting period and from the budget, regularly monitored?
  - d. Is sufficient information available to permit an analysis of the cause of interest margin variations?
3. Does the foregoing information provide an adequate basis for evaluating internal controls in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

# Litigation and Other Legal Matters; Examination-Related Subsequent Events

Effective date May 1996

Section 4100.1

## LITIGATION AND OTHER LEGAL MATTERS

Events or conditions arising from litigation,<sup>1</sup> claims, and assessments are matters within the direct knowledge and, often, control of bank management. Accordingly, management is the primary source of information about these matters.<sup>2</sup> Examiners ordinarily do not possess legal skills and therefore cannot make legal judgments on such information. The examiner should request that bank management send a letter of inquiry to those attorneys with whom it has consulted on litigation, claims, and assessments. The letter of inquiry is the examiner's primary means of corroborating information furnished by management.

When requesting these inquiries, the examiner should consider the scope of counsel's involvement with the bank. Banks frequently engage a number of law firms, so the examiner should have the bank direct requests to both general counsel and counsel whose service is limited to particular matters. Ordinarily, inquiries should be made of all outside counsel.

In certain instances, however, the examiner may be reasonably certain that some of the bank's counsels are handling only routine matters that ultimately won't have a significant effect on the bank's financial condition. In these cases, the examiner-in-charge may decide not to send letters of inquiry to those counsels.

Requests for corroboration from legal counsel should ask for information about litigation, impending litigation, claims, and contingent liabilities. For the purposes of these requests, the terms impending litigation and contingent liabilities have the following meanings:

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1. Legal or litigation risk is the risk that contracts are not legally enforceable or documented properly. Legal risks should be limited and managed through policies developed by the institution's legal counsel. At a minimum, guidelines and processes should be in place to ensure the enforceability of counterparty agreements.

2. In limited circumstances, a bank director who is not an officer of the bank may have direct knowledge and control of legal information, usually when the director's primary occupation is as an attorney. Management in these rare instances may have limited knowledge and control of legal information.

- *Impending litigation.* Litigation threatened against the bank by a third party but not formally commenced.
- *Contingent liabilities.* Matters other than litigation or claims, which available information indicates have at least a reasonable possibility of impairing assets or increasing liabilities. Contingent liabilities should include unasserted claims or assessments.

A letter of inquiry should ask for a response both as of the examination date and as of the date of counsel's response. That date of response should be as close to the completion of the examination as practicable, yet should allow sufficient time for evaluation of responses and follow-up of nonreplies. In some cases, the examiner may wish to obtain an interim response (in addition to a final response) so that a timely preliminary evaluation of material legal matters may be made. Letters of inquiry should be mailed early enough to allow them to circulate within the law firm because several attorneys may be considering legal matters for the bank. Before completing the examination, the examiner should request that appropriate bank officials contact counsel who have not responded to the initial letter of inquiry.

The examiner should not assume that bank management or counsel will keep him or her informed of developments subsequent to the date of counsel's response. Accordingly, if there is reason to believe that there may be subsequent developments, the examiner should contact bank management again before submitting the report of examination. If bank management is uncooperative or regarded as incapable of supervising matters concerning litigation, or if other sensitivities mandate circumvention of bank management, then the examiner should bring the matter to the attention of Federal Reserve Bank management for further communications with the bank's management and counsel, which could include direct contact with bank counsel.

## EXAMINATION-RELATED SUBSEQUENT EVENTS

As a practical matter, the examination, and therefore the report of examination, is as of a



stated date. However, events or transactions sometimes occur, subsequent to the date of examination, but before the date the report of examination is submitted to the Reserve Bank, that may have a significant effect on the soundness of a bank. Such events and transactions are referred to as “subsequent events” and may be of two types.

One type includes those events or transactions that provide additional evidence about conditions that existed at the examination date. Examples of this type are the bankruptcy of a significant borrower or the resolution of outstanding litigation.

The second type includes those events that provide evidence about conditions that did not

exist at the date of examination, but that arose subsequently. An example of that type of event would be new litigation arising subsequent to the examination date but before submission of the examination report or a merger agreement signed subsequent to the examination date.

All information that becomes available before the submission of the report of examination should be used by the examiner in his or her evaluations of the bank. Accordingly, all events or transactions that either significantly affect or have the potential to significantly affect the soundness of the bank should be reflected in the report of examination, regardless of whether they occurred before or subsequent to the examination date.

# Litigation and Other Legal Matters; Examination-Related Subsequent Events

## Examination Objectives

Effective date May 1996

## Section 4100.2

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1. To determine whether any events or transactions have occurred subsequent to the examination date that have had or may have a significant impact on the present or future soundness of the bank or on the conclusions expressed in the report of examination.
2. To determine the effect of legal counsel's evaluation of litigation, impending litigation, claims, and contingent liabilities on the examiner's overall conclusion regarding the soundness of the bank.

# Litigation and Other Legal Matters, Examination-Related Subsequent Events

## Examination Procedures

Effective date March 1984

## Section 4100.3

1. Obtain from the bank officer responsible for legal matters a listing of impending or threatened litigation. For each item, the following information should be included:
  - a. nature of the litigation
  - b. progress of case to date
  - c. how management is responding or intends to respond to the litigation
  - d. an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss
2. Obtain from the bank officer responsible for legal matters a listing of unasserted claims or assessments management considers will probably be asserted and which, if asserted, would have at least a reasonable possibility of an unfavorable outcome. For each item, the following information should be included:
  - a. nature of the matter
  - b. how management intends to respond if the claim is asserted
  - c. possible exposure if the claim is asserted
3. Obtain from management a listing of attorneys and legal firms to whom litigation and related matters have been referred. Also, obtain a listing of any litigation noted in the newest review done by internal or external auditors from the examiner assigned internal control, and determine that corrections have been accomplished.
4. Review bills supporting major charges to the general ledger expenses account(s) for legal services as a test of the completeness of the list supplied by the bank.
5. Request that management incorporate information obtained in above steps in a letter to the bank's legal counsel for corroboration.
6. Evaluate management's listing of litigation, unasserted claims and assessments, and counsel's replies for the effect on the financial condition of the bank, giving appropriate consideration to any insurance coverage.
7. Obtain and review copies of any subsequent interim financial statements. Examples of such statements are—
  - a. published reports sent to shareholders or others
  - b. reports submitted to the board of directors by internal auditors, external auditors, or management
  - c. statements of condition
  - d. income statements
  - Inquire as to whether interim statements obtained were prepared on the same basis as that used for the statements as of the examination date. If not, request proper adjustments to the interim statements.
  - Compare the interim financial statements, especially income statements, with similar statements for the corresponding period in the prior year and to budgets, profit plans, etc., for the current period, if such are available.
  - Obtain from management satisfactory explanations for any unusual items or significant fluctuations noted.
8. Make inquiries of and hold discussions with officers and other executives who have responsibility for the following matters:
  - a. changes in credit lines or transactions with officers, directors, controlling shareholders, affiliated bank holding companies, affiliates of an affiliated holding company, or their interests
  - b. changes in significant accounting policies
  - c. changes in senior officers
  - d. any event or combination of events which have had or could have a material adverse effect on the bank's financial condition, including liquidity, or results of operation, such as the default of a bond issue in which the bank has substantial holdings or the filing of bankruptcy by a major borrower
  - e. commencement or discontinuance of services not requiring prior approval
  - f. execution of significant contracts, such as for employment, leases, pension, or other fringe benefit programs
  - g. significant new contingent liabilities or commitments other than those referred to above
  - h. significant changes in assets which may not be evident from the review of subsequent interim financial statements, such as a shift in the amount of loans or

- investments in special categories, or unusual adjustments made in or after the subsequent interim financial statements reviewed in connection with step 7 above
9. Distribute information obtained in step 8 to the appropriate examiners.
  10. Read minutes of all meetings of stockholders, directors, and appropriate committees (investment, loans, etc.).
    - a. Ascertain from officials of the bank whether minutes of all such meetings subsequent to the examination date are set forth in the minute book.
    - b. As to meetings for which minutes have not been prepared at the date of the review, inquire directly of persons present at the meetings and, preferably, of the person charged with the responsibility of preparing the minutes, concerning matters dealt with at such meetings.
  11. If specific violations of law or areas of weakness have been reported to management earlier in the examination, determine the extent to which management has proceeded toward corrective action.
  12. Make additional inquiries or perform such procedures as considered necessary and appropriate to dispose of questions that arose in the course of the preceding procedures, inquiries, and discussions.
  13. If, as a result of performing the above procedures, information is obtained that has a significant impact on the evaluation of the soundness of the bank, extend the appropriate examination procedures so that sufficient evidence is reviewed and documented in the workpapers to support the conclusions reached.
  14. Prepare comments for the examination report on any events or transaction noted which may have a material effect on the soundness of the bank.
  15. Update the workpapers with any information that will facilitate future examinations.

# Contingent Claims from Off-Balance-Sheet Credit Activities

## Section 4110.1

Effective date November 1995

### INTRODUCTION

Off-balance-sheet credit activities have been one of the fastest growing areas of banking activity. Although these activities may not be reflected on the balance sheet, they must be thoroughly reviewed because they can expose the bank to contingent liabilities. Contingent liabilities are financial obligations of a bank that are dependent on future events or actions of another party.

The purpose of this section is to provide a concise reference for contingent liabilities that arise from off-balance-sheet credit activities (for example, loan commitments and letters of credit). This section will also include some discussion of other contingent liabilities, which arise from asset sales and other off-balance-sheet activities. Activities such as trusts, securities clearance, securities brokerage, and corporate management advisory services involve significant operational and fiduciary risks and require specialized examination procedures. Consult section 6010, "Other Types of Examinations," in this manual for further information about these activities.

Derivatives are also not covered in this section. The acquisition and management of derivatives for the bank's own account are covered in detail in sections 2020 and 4090, "Acquisition and Management of Nontrading Securities and Derivative Instruments" and "Interest-Rate Risk Management" of this manual. The *Trading Activities Manual* provides more specific guidance for the examination of banks that are involved in derivatives trading and customer accommodation activities.

Risks associated with contingent liabilities may ultimately result in charges against capital. As a result, full-scope examinations will include an analysis of these risks. Each of the major components of the examination—capital, asset quality, management, liquidity, and earnings—incorporates an assessment of the risks associated with off-balance-sheet credit activities. While it is impossible to enumerate all of the types and characteristics of contingent liabilities here, some of the more common ones are discussed in this section. In all cases, the examiner's overall objectives are to assess the potential impact of these contingent liabilities on the financial condition of the bank, to ascertain the likelihood that such contingencies may ultimately result in losses to the bank, to ensure that management has appropriate systems to identify

and control contingent liabilities, and to ensure compliance with all applicable laws, regulations, and statements of regulatory policy.

### OFF-BALANCE-SHEET LENDING ACTIVITIES

In reviewing individual credit lines, all of a customer's borrowing arrangements with the bank (for example, direct loans, letters of credit, and loan commitments) should be considered. The factors analyzed in evaluating a direct loan (financial performance, ability and willingness to pay, collateral protection, and future prospects) are applicable to the review of off-balance-sheet lending arrangements. When analyzing these activities, however, examiners should evaluate the probability of draws under the bank's off-balance-sheet lending arrangements with its customers and should evaluate whether the allowance for loan and lease losses adequately reflects the associated risks. Consideration should also be given to compliance with laws and regulations. Refer to section 2040, "Loan Portfolio Management," of this manual for further details.

### Loan Commitments

A formal loan commitment is a written agreement signed by the borrower and the lender that details the terms and conditions under which a loan, up to a specified amount, will be made. Unlike a standby letter of credit, which commits the bank to satisfying its customer's obligation to a third party, a loan commitment involves only the bank and its customer. The commitment will have an expiration date and, in exchange for agreeing to make the accommodation, the bank often requires the customer to pay a fee and/or maintain a stipulated compensating balance.

Some commitments, such as a working capital line, revolving credit facility, or a term loan facility, are expected to be used. Other commitments, such as back-up lines of credit for commercial paper issuance, involve usage that is not anticipated unless the customer is unable to retire or roll over the issue at maturity.

## Lines of Credit

A line of credit expresses to the customer, usually by letter, a bank's willingness to lend up to a certain amount over a specified timeframe. These lines of credit are disclosed to the customer and are referred to as "advised" or "confirmed" lines. In contrast, "guidance" lines (also referred to as internal guidance lines) are not disclosed to the customer. "Guidance" lines of credit are formally approved like any other loans or commitments and are established to aid the loan officer who is servicing an account act quickly to an unexpected request for funds. Many lines of credit may be cancelled if the customer's financial condition deteriorates; others are simply subject to cancellation at the option of the issuer, such as "guidance" lines and other nonbinding agreements. Lines of credit usually require periodic or annual borrowing cleanups. Not adhering to cleanup provisions is a well-defined weakness.

Disagreements may arise as to what constitutes a legally binding commitment. A bank's own descriptive terminology alone may not always be the best guideline. For example, a credit arrangement could be referred to as a revocable line of credit but, at the same time, it may be a legally binding commitment to lend—especially if consideration has been given by the customer for the bank's promise to lend and if the terms of the agreement between the parties result in a contract. Therefore, management of the bank should properly distinguish its legally binding loan commitments from its revocable loan commitments. Proper documentation will help ensure that the bank's position is defensible if legal action becomes necessary to cancel a loan commitment.

Some lending agreements contain a "material adverse change" (MAC) clause, which is intended to allow the bank to terminate the commitment or line of credit if the customer's financial condition deteriorates. This clause may apply to the continuing financial condition of guarantors. The extent to which MAC clauses are enforceable depends on several factors, including whether a legally binding relationship remains despite specific financial covenants that are violated. Some documents make only a vague reference to a borrower's responsibility for maintaining a satisfactory financial condition. Although the enforceability of MAC clauses may be subject to some uncertainty, such clauses

may provide the bank with leverage in negotiations with the customer over such issues as requests for additional collateral and/or personal guarantees.

A bank cannot always routinely determine whether funding of a commitment or line of credit will be required; therefore, the examiner must always subject the line of credit to careful analysis. A MAC clause could allow the bank to refuse funding to a financially troubled borrower; a default in other contract covenants could cause the termination of the commitment or line of credit. Some banks might strictly enforce the terms of a credit arrangement and refuse funding if any of the covenants are broken. Other banks take a more accommodating approach and will continue to make advances unless the customer files for bankruptcy. In the final analysis, the procedures normally followed by the bank in honoring or terminating a contingent lending agreement are important in the examiner's overall evaluation of the credit risk.

## Risk Management for Loan Commitments and Lines of Credit

The primary risk inherent in any future extension of credit is that the condition of the borrower may change between the issuing of the commitment and its funding. However, commitments may also entail liquidity and interest-rate risk.

Examiners should evaluate anticipated draw-downs of an issuing bank's loan commitments and lines of credit relative to the bank's anticipated funding sources. A draw under lines of credit may be in the form of a letter of credit issued on the borrower's behalf. Such letters of credit share the same collateral as the line of credit, and the issuance of the letter of credit uses availability under the line. At each examination, the draws that are anticipated for unused commitments and advised lines of credit should be estimated. If the amount of unfunded commitments is large relative to the bank's liquidity position, further analysis is suggested to determine whether borrowed funds will have to be used and, if so, the amount and sources of such funds. Concerns and comments should be noted on the Liquidity/Funds Management page in the report of examination. Also, loan commitments are to be reported on the commitments and contingencies schedule in the report of exami-

nation. For further information, refer to sections 4020, 4090, and 6000, “Asset/Liability Management,” “Interest-Rate Risk Management,” and “Instructions for the Report of Examination,” in this manual.

## LETTERS OF CREDIT

A letter of credit substitutes the credit capacity of a financial institution for that of an individual or a corporation. The concept of substituting one obligor’s financial standing for another party’s financial standing has been used in financing the international shipment of merchandise for centuries (imports and exports). Today, letters of credit are also used in a wide variety of other commercial financing transactions, such as guaranteeing obligations involving the private placement of securities and ensuring payment in the event of nonperformance of an obligated party. In addition, letters of credit are used to secure the guarantees of principals in real estate development loans. For additional information on letters of credit, see section 7080, “International—Letters of Credit,” in this manual.

### Elements of a Letter of Credit

A letter of credit should contain the following elements:

- a conspicuous statement that the document is a letter of credit
- a specified expiration date or a definite term and an amount
- an obligation of the issuer to pay that is solely dependent on the presentation of conforming documents as specified in the letter of credit and not on the factual performance or nonperformance by the parties to the underlying transaction
- an unqualified obligation of the account party to reimburse the issuer for payments made under the letter of credit

A letter of credit involves at least three parties and is three separate and distinct contracts:

- a contract between the account party and the beneficiary under which the account party has an obligation of payment or performance

- a contract between the account party and the issuer of the letter of credit (The issuer is the party obligated to pay when the terms of the letter of credit are satisfied. The account party agrees to reimburse the issuer for any payments made.)
- a contract between the issuer and the beneficiary, whereby the issuer agrees to pay the beneficiary in compliance with the terms and conditions of the letter

### Policies and Procedures

Maintaining adequate written policies and procedures and monitoring letters of credit activities are part of the fiduciary and oversight responsibilities of the board of directors. Generally, policies and procedures governing the institution’s issuance of letters of credit are contained in a section of the loan policy manual.

The letter of credit policy should thoroughly explain the institution’s procedures in issuing both commercial letters of credit and standby letters of credit. The policy should outline desirable and undesirable issuances, designate persons authorized to issue letters of credit and their corresponding loan authority, and define the recordkeeping and documentation requirements including the need to establish separate files for each issuance.

If several lending departments issue letters of credit, the policy should explicitly assign responsibility for file maintenance and recordkeeping. A separate file containing an exact copy of each outstanding letter of credit and all the supporting documentation that the underwriter used in deciding to issue the letter should be included in the file. This documentation should be the same as the financial documentation used for originating any other form of credit, which includes current financial statements, current income statements, purpose of the letter of credit, collateral-security documentation, proof-of-lien position, borrowing authorization, all correspondence, and officers’ memoranda.

### Documentation

In addition, the file must contain the documentation associated with any disbursements or payments made. For a commercial letter of credit, these documents may include—

- the draft (sometimes called the bill of exchange), which is the demand for payment;
- the commercial invoice, a document describing the goods being shipped (prepared by the seller and signed by the buyer);
- the bill of lading, which documents that shipment of the goods has taken place and gives the issuer an interest in the goods in the event the account party defaults;
- customs documentation that verifies that all required duties have been paid;
- the insurance certificate, which provides evidence that the seller has procured insurance;
- the consular documents, which state that the shipment of goods satisfies the import/export regulations; and
- the certificates of origin and inspection, which state that the goods originated in a specified country to guard against the substitution of second-quality merchandise.

The documents associated with standby letters of credit are far less complicated than those for commercial letters of credit. Often no document is necessary to support the beneficiary's draw upon a standby letter of credit. This is what is referred to as a clean standby letter of credit and should be discouraged due to the possible legal expense of defending any action taken in honoring or dishonoring a draw without specific documentary requirements. At a minimum, standby letters of credit should require a beneficiary's certificate asserting that the account party has not performed according to the contract or has defaulted on the obligation, as well as a copy of the contract between the account party and beneficiary.

## Accounting Issues

Since letters of credit represent a contingent liability to the issuing institution, they must be disclosed in the financial statements in accordance with generally accepted accounting principles (GAAP). The Financial Accounting Standards Board has stipulated in its Statement of Financial Accounting Standard No. 5 that the nature and the amount of a standby letter of credit must be disclosed in the institution's financial statement. Commercial letters of credit and standby letters of credit should be accounted for on the balance sheet as liabilities if it is probable that the bank will disburse funds, and if

the amount of the funding is determinable. Most standby letters of credit will not be recorded as a liability. However, their existence will be disclosed in the footnotes to the financial statements.

## Benefits of Letters of Credit

Both the customer and the financial institution can benefit from letters of credit. Through the use of a letter of credit, a customer can often obtain a less expensive source of funds than would be possible through direct financing from the institution. For example, the customer may be able to take advantage of a seller's credit terms with the backing of a letter of credit to substantiate the customer's credit capacity. The institution receives a fee for providing the service. In addition, the institution hopes to build a better working relationship with its customers, who may generate or refer other profitable business.

## Revocable or Irrevocable

Letters of credit can be issued as either revocable or irrevocable. The revocable letter of credit is rarely used because it may be amended or canceled by the issuer without the consent of the other parties. Most letters of credit are issued as irrevocable with a stipulation that no changes may be made to the original terms without the full consent of all parties.

## Risks in Issuing Letters of Credit

A financial institution must be aware of the credit risks that are associated with letters of credit and must issue letters of credit only when its resources are adequate. Although letters of credit are not originally made as loans, they may lead to loans if the account party cannot meet its obligations. Therefore, the institution must implement the same prudent underwriting guidelines for letters of credit as for other extensions of commercial credit. Refer to section 2080, "Commercial Loans," in this manual for further details.

The importance of adequate documentation cannot be overemphasized. Commercial letters of credit are part of a continuous flow of



transactions evolving from letters of credit to sight drafts to acceptances. Repayment may depend on the eventual sale of the goods involved; however, the goods may not provide any collateral protection. Thus, proper handling and accuracy of the required documents are of primary concern. Letters of credit are frequently issued via tested telex, which verifies the authenticity of the sender (usually another bank). No institution should honor a letter of credit presented by a beneficiary without first confirming its authenticity.

Commercial letters of credit involving imports must be considered unsecured until the goods have passed customs, the security documents specified in the letter of credit have been presented, and the goods have been verified and controlled.

Letters of credit are subject to the risk of fraud perpetrated by customers, beneficiaries, or insiders of the issuing institution. Moreover, standby letters of credit can be used by officers or directors as a vehicle for obtaining credit at another institution. It is important to note that Regulation O requirements apply to standby letters of credit.

Consequently, letters of credit should be issued under the same strict internal controls as any other extension of credit. Such controls include a requirement of dual or multilevel authorizations and the segregation of the issuing, record-keeping, acceptance, and payment functions.

## Risks in Honoring Letters of Credit

The honoring of another institution's letter of credit or acceptance requires strict verification procedures as well as dual authorization by the honoring financial institution. Reasons for strict procedures and authorizations are numerous. The issuer may be unable or unwilling to honor a letter of credit or standby letter of credit, claiming that the document is fraudulent or a forgery or that the signer was unauthorized. Before honoring any other institution's letter of credit, a bank should confirm in writing that the letter of credit is valid and will be honored under specified conditions. Agreements with issuers for accepting letters of credit issued by tested telex should provide specific conditions under which they will be honored.

To minimize risks of loss, compliance with the conditions outlined within the letter of credit

must be strict—not merely substantial. Testing of LOCs should involve two or more persons through dual authorization or segregation of duties to prevent fraud by employees in this process.

## Uniform Commercial Code

Both the issuer and the beneficiary of letters of credit are obligated to conform to a uniform set of rules governed by article 5 of the Uniform Commercial Code (UCC). These rules are referenced in the Uniform Customs and Practice for Documentary Credits (UCP). The UCC is a set of articles governing commercial transactions adopted by various states, whereas the UCP encompasses all of the international guidelines for trading goods and services. Local laws and customs vary and must be followed under advice of counsel.

## TYPES OF LETTERS OF CREDIT

There are two major types of letters of credit: the commercial letter of credit, also referred to as a trade letter of credit, and the standby letter of credit. Banks have significantly increased their issuances of letters of credit, particularly standby letters. A contributing factor to this significant increase is that by issuing letters of credit, an institution can increase its earnings without disbursing funds and increasing total assets. The institution charges a fee for the risk of default or nonperformance by the customer, thereby increasing the bank's return on average assets. It is important for examiners to be concerned with the elements of risk that are present in the institution's practices regarding the issuance of letters of credit. Examiners should then assess the institution's system of controls that can mitigate the risks (including staff experience, proper documentation, and the quality of underwriting). The standards for issuing letters of credit should be no less stringent than the standards for making a loan. Likewise, the letter-of-credit portfolio requires a review as thorough as the lending review. A default or nonperformance by the account party of a letter of credit will have the same impact as a default on a loan.

## Commercial Letters of Credit

The commercial letter of credit (LOC) is commonly used as a means of financing the sale of goods between a buyer and seller. Generally, a seller will contract with a buyer on an open-account basis, whereby the seller ships the goods to the buyer and submits an invoice. To avoid the risk of nonpayment, the seller may require the buyer to provide a commercial letter of credit. To satisfy the requirement, the buyer applies for a letter of credit at a financial institution. If approved, the letter of credit would contain specified terms and conditions in favor of the seller (beneficiary), and the buyer (account party) would agree to reimburse the financial institution for payments drawn against the letter. The commercial letter of credit can be used to finance one shipment or multiple shipments of goods. Once documents that provide evidence that the goods have been shipped in accordance with the terms of the letter of credit are received, the seller can draw against the issued letter of credit through a documentary draft or a documentary demand for payment. The institution honors the draft, and the buyer incurs an obligation to reimburse the institution.

Letters of credit can be secured by cash deposits, a lien on the shipped goods or other inventory, accounts receivable, or other forms of collateral. Commercial letters of credit “sold for cash” (that is, secured by cash deposits) pose very little risk to a bank as long as the bank, before making payment on the draft, ensures that the beneficiary provides the proper documents. If credit is extended to pay for the goods, the subsequent loan presents the same credit risks associated with any other similar loan.

## Standby Letters of Credit

The standby letter of credit (SBLOC) is an irrevocable commitment on the part of the issuing institution to make payment to a designated beneficiary if the institution’s customer, the account party, defaults on an obligation. The SBLOC differs from the commercial letter of credit because it is not dependent on the movement of goods. While the commercial letter of credit eliminates the beneficiary’s risk of nonpayment under the contract of sale, the SBLOC eliminates the financial risks resulting from nonperformance under a contract. The SBLOC,

in effect, enhances the credit standing of the bank’s customer.

SBLOCs may be financially oriented (financial SBLOCs), whereby an account party agrees to make payment to the beneficiary, or SBLOCs may be service-oriented (performance SBLOCs), whereby the financial institution guarantees to make payment if its customer fails to perform a nonfinancial contractual obligation.

### *Financial SBLOCs*

Financial SBLOCs are often used to back direct financial obligations such as commercial paper, tax-exempt securities, or the margin requirements of exchanges. For example, if the bank’s customer issues commercial paper supported by an SBLOC, and the bank’s customer is unable to repay the commercial paper at maturity, the holder of the commercial paper may request the bank to make payment. Upon receipt of the request, the bank would repay the holders of the commercial paper and account for the payment as a loan to the customer under the letter of credit. Because of this irrevocable commitment, the bank has, in effect, directly substituted its credit for that of its customer upon the issuance of the SBLOC; consequently, the SBLOC has become a credit enhancement for the customer.

### *Performance SBLOCs*

Performance SBLOCs are generally transaction-specific commitments that the issuer will make payment if the bank’s customer fails to perform a nonfinancial contractual obligation, such as to ship a product or provide a service. Performance SBLOCs are often used to guarantee bid or performance bonds. Through a performance SBLOC, the bank provides a guaranty of funds to complete a project if the account party does not perform under the contract. In contrast to the financial SBLOC, the bank’s irrevocable commitment provides liquidity to the obligor and not directly to a third-party beneficiary.

Unlike a commercial letter of credit, a demand for payment against an SBLOC is generally an indication that something is wrong. The non-performance or default that triggers payment under the SBLOC often signals the financial weakness of the customer, whereas payment under a commercial letter of credit suggests that

the account party is conducting its business as usual. Standby letters of credit can be either unsecured or secured by a deposit or other form of collateral.

### Uses

The uses of standby letters of credit are practically unlimited. The more common areas of use include the following.

*Financing Real Estate Development.* A mortgagee will condition its loan commitment upon a cash contribution to a project by the developers. Although the lender insists that the developers have some equity in the project, the developer may not have funds available as they are tied up in other projects. The parties often use the letter of credit to satisfy the requirement for equity without the need for a cash deposit.

*Fulfilling Municipal Regulations.* Most municipalities require some form of a performance bond to ensure that infrastructure improvements, such as buildings, roads, and utility services, are completed. Because the bonding companies generally required a letter of credit as collateral for their bond, developers began offering the SBLOC to the municipality as a substitute. The SBLOC is probably more common than the performance bond. The SBLOC provides the municipality the guaranty of funds to complete necessary improvements if the developer does not perform as required.

*Securing Notes.* A lender will sometimes ask its obligor to secure the balance of a promissory note with an SBLOC issued by another bank.

*Ensuring Performance.* The standby letter of credit is similar to a performance bond. Often the seller of goods will have the borrower obtain a commercial letter of credit to ensure payment; simultaneously, the buyer will have the seller obtain a standby letter of credit to ensure that the goods are delivered when agreed and in acceptable condition.

*Guaranteeing Securities.* The standby letter of credit guarantees obligations involving the private placement of securities, such as revenue and development bonds. If an SBLOC secures against default, such paper will generally have a

higher rating and bear a lower rate of interest. An SBLOC could also be used as a credit enhancer for packaging retail loans for public sale. The use of an SBLOC in this situation typically carries minimal overall risk because the packaging institution normally sets aside a contingent reserve for losses. However, if the reserve is inadequate, the SBLOC should be reviewed for possible classification.

### *SBLOCs Issued as Surety for Revenue Bonds*

SBLOCs may be issued in conjunction with the development of a property that is financed with tax-free or general revenue bonds. In these transactions, a municipal agency—typically, a local housing authority or regional development authority—sells bonds to investors in order to finance the development of a specific project. Once the bonds are issued, the proceeds are placed with a trustee and then loaned at less than market rates to the developer of the project. The below-market-rate loan that is granted to the developer enables the municipal agency to encourage development without expending tax dollars. The municipal agency has no liability; the bond investors only have recourse against the specific project. If the bonds are exempt from federal taxation, they will generally carry a below-market interest rate. If the bonds are not tax free—and some municipal bonds are not tax free—they will carry a market rate of interest.

Because the bonds are secured only by the project, an SBLOC is typically obtained by the beneficiary (in this example, the municipal agency) from a financial institution to provide additional security to the bondholders. The SBLOC is usually for an amount greater than the face amount of the bonds, so the bondholders' accrued interest between interest payment dates is usually secured. The bank generally secures its SBLOC with a lien that is subordinate to the authority's or trustees' lien against the property and the personal guarantees of the principal. Underwriting standards and credit analysis for SBLOCs should mirror those employed for direct loans.

The trustee receives periodic payments from the developer and then pays the bondholders their periodic interest payments and also pays the financial institution its letter-of-credit fee. In the event of a default by the developer, the trustee will draw upon the SBLOC to repay the

bondholders. If such a default occurs, the issuing financial institution assumes the role of the lender for the project.

The structure of the transaction requires the bank issuing the SBLOC to assume virtually all of the risk. Because the purpose of these bonds is to encourage development, financially marginal projects, which would not be feasible under conventional financing, are often financed in this manner. The primary underwriting consideration is the ability of the securing property to service the debt. The debt-service-coverage calculations should include both the tax-free rate, if applicable, obtained through the revenue bonds and market interest rates. The operations of the securing property should also be monitored on an ongoing basis. If new construction is involved, the progress should be monitored and any cost overruns should be identified and addressed.

### *Renewal of SBLOCs*

Although most SBLOCs contain periodic renewal features, the examiner must be aware that the bank cannot relieve itself from liability simply by choosing not to renew the SBLOC. Virtually all of the bond issues require a notice of non-renewal before the expiration of the SBLOC. If such notice is received by the trustee, the trustee normally considers the notice an event of default and draws against the existing SBLOC. The bank should protect itself, therefore, by continuously monitoring both the project and the status of the bonds. Documentation should be maintained in the bank's file to substantiate the property's occupancy, its cashflow position, and the status of the bonds. In addition to the current status of interest payments, any requirements for a sinking fund that are contained in the bond indenture should also be monitored.

Some letters of credit are automatically renewable unless the issuing bank gives the beneficiary prior notice (usually 30 days). These letters of credit represent some additional risk because of the notification requirement placed on the bank. As noted above, proper monitoring and timely follow-up are imperative to minimize risk.

Without the benefit of a substantial guarantor or equity in the collateral, these SBLOCs present more than normal risk of loss. If the SBLOC is converted into an extension of credit, the loan will likely be classified substandard or worse.

Protection against loss may be provided by a long-term lease from a major tenant of an industrial property or a lease from a housing authority with a governmental funding commitment or guaranty.

### *Classification of SBLOCs*

It may be appropriate to adversely classify an SBLOC if draws under the SBLOC are probable and a well-defined credit weakness exists. For example, deterioration of the financial standing of the account party could jeopardize performance under the letter of credit and result in the requirement of payment to the beneficiary. Such a payment would result in a loan to the account party and could result in a collection problem, especially if the SBLOC was unsecured. If payment is probable and the account party does not have the ability to repay the institution, an adverse classification is warranted. FASB 5 requires that if a loss contingency is probable and can be reasonably estimated, a charge to income must be accrued. Refer to section 2060, "Classification of Credits," in this manual for procedures on SBLOC classification.

## **BANKER'S ACCEPTANCES**

When the beneficiary presents a draft to the issuer in compliance with the terms of a commercial letter of credit, the method of honoring the draft is acceptance. The issuer will stamp the word "accepted" across the face of the draft, which makes the instrument negotiable. Thus, the institution upon which the draft is drawn converts what was originally an order to pay into an unconditional promise to pay. Depending on the terms specified in the letter of credit, payment of the draft can vary from sight to 180 days. There is a ready market for these instruments, because payment must be made at maturity by the accepting institution, whether or not it is reimbursed by its customer. These acceptances are readily negotiable, and a beneficiary may sell accepted time drafts to other financial institutions at a discount. Acceptances are governed by article 3 of the UCC, and any rights the parties have under acceptance are subject to the rules of that article. For further discussion of banker's acceptances, see section 7060, "International—Banker's Accep-

tances,” and the Instructions for the Preparation of the Report of Condition and Income.

## Participations in Banker’s Acceptances

The following discussion refers to the roles of accepting and endorsing banks in banker’s acceptances. It does not apply to banks purchasing other banks’ acceptances for investment purposes. Banker’s acceptances may represent either a direct or contingent liability of the bank. If the acceptance is created by the bank, it constitutes a direct liability that must be paid on a specified future date. The acceptance is also an on-balance-sheet, recognized liability. If a bank participates in the funding risk of an acceptance created by another bank, the liability is contingent and the item is carried off-balance-sheet. The financial strength and repayment ability of the accepting bank should be considered in analyzing the amount of risk associated with these contingent liabilities.

Participations in acceptances conveyed to others by the accepting bank include transactions that provide for the other party to the participation to pay the amount of its participated share to the accepting bank at the maturity of the acceptance, whether or not the account party defaults. Participations in acceptances acquired by the nonaccepting bank include transactions that provide for the nonaccepting bank to pay the amount of its participated share to the accepting bank at the maturity of the acceptance, whether or not the account party defaults.

### *Call Report Treatment*

For regulatory reporting purposes, the existence of such participations is not to be recorded on the balance sheet. Rather, both the accepting bank conveying the participation to others and the bank acquiring the participation from the accepting bank must report the amounts of such participations in the appropriate item in Schedule RC-L, Commitments and Contingencies. (The amount of participations in acceptances reported in Schedule RC-L by a member bank may differ from the amount of such participations that enter into the calculation of the bank’s acceptances to be counted toward its acceptance limit imposed by section 13 of the Federal

Reserve Act (12 USC 372). These differences are mainly attributable to participations in ineligible acceptances, to participations with “uncovered” institutions, and to participations that do not conform to the minimum requirements set forth in 12 CFR 250.163.)

## NOTE-ISSUANCE AND REVOLVING UNDERWRITING CREDIT FACILITIES

The first note-issuance facility (NIF) was introduced in 1981. A NIF is a medium-term (five- to seven-year) arrangement under which a borrower can issue short-term paper. The paper is issued on a revolving basis, with maturities ranging from as low as seven days to up to one year. Underwriters are committed either to purchasing any unsold notes or to providing standby credit. Bank borrowing usually involves commercial paper consisting of short-term certificates of deposit and, for nonbank borrowers, generally promissory notes (Euronotes). Although NIF is the most common term used for this type of arrangement, other terms include the revolving underwriting facility (RUF) and the standby note-issuance facility (SNIF).

Another type of facility, a RUF, was introduced in 1982. A RUF is a medium-term revolving commitment to guarantee the overseas sale of short-term negotiable promissory notes (usually a fixed-spread over LIBOR) issued by the borrower at or below a predetermined interest rate. RUFs separate the roles of the medium-term risk-taker from the funding institutions (the short-term investors). RUFs and NIFs allow access to capital sources at interest rates considerably below conventional financing rates. The savings in interest cost are derived because the borrower obtains the lower interest costs prevailing in the short-term markets, while still retaining the security of longer term financing commitments. The notes issued under RUFs are attractive for institutional investors since they permit greater diversification of risk than the certificates of deposit of only one bank. Underwriters favor them because their commitments do not appear on the statement of financial condition. RUFs are usually structured for periods of four to seven years.

A RUF differs from a NIF in that it separates the functions of underwriting and distribution. With a RUF, the lead bank (manager or arranger)

acts as the only placing agent. The arranger retains total control over the placing of the notes.

NIFs and RUFs are discussed further in the *Bank Holding Company Supervision Manual*.

## GUARANTEES ISSUED

State member banks and foreign branches of U.S. banks are allowed to issue guarantees or sureties under certain circumstances. Such guarantees are to be reported as contingent liabilities in Schedule RC-L. Refer to section 7090, “International—Guarantees Issued,” of this manual and to the call report instructions for further information.

## ASSET SALES

The term “asset sales,” in the following context, encompasses the range of activities from the sale of whole loans to the sale of securities representing interests in pools of loans. Asset-sales programs entail establishing both a portfolio of assets that are structured to be easily salable and a distribution network to sell the assets. Most large banks have expended great effort in developing structures and standard procedures to streamline asset-sale transactions and continue to do so.

Asset sales, if done properly, can have a legitimate role in a bank’s overall asset and liability management, and can contribute to the efficient functioning of the financial system. In addition, these activities can assist a bank in diversifying its risks and improving its liquidity.

The benefits of a qualifying sale transaction are numerous. In particular, the sale of a loan reduces capital requirements. The treatment also enhances net income, assuming that the loan was sold for a profit.

Banks’ involvement in commercial loan sales and in public issuance of mortgage and asset-backed securities has grown tremendously over the last decade. Banks are important both as buyers and sellers of whole loans, loan participations, and asset-backed securities. Banks also play important roles in servicing consumer receivables and mortgages backing securities and in providing credit enhancement to originators of primarily asset-backed securities.

Both whole loans and portions of loans are sold. Banks sell portions of loans through participation arrangements and syndication agreements.

## Participations

A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, a lead bank originates the loan and sells ownership interests to one or more participating banks at the time the loan is closed. The lead bank (originating bank) normally retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. Properly structured, loan participations allow selling banks to accommodate large loan requests that would otherwise exceed lending limits, to diversify risk, and to improve liquidity by obtaining additional loanable funds. Participating banks are able to compensate for low local demand for loans or invest in large loans without their servicing burdens and origination costs. If not appropriately structured and documented, however, a loan participation can present unwarranted risks to both the seller and purchaser of the loan. Examiners should determine the nature and adequacy of the participation arrangement and should analyze the credit quality of the loan. For further information on participations, refer to section 2040, “Loan Portfolio Management,” in this manual.

## Syndication

A syndication is an arrangement in which two or more banks lend directly to the same borrower pursuant to one loan agreement. Each bank in the syndicate is a party to the loan agreement and receives a note from the borrower evidencing the borrower’s debt to that bank. Each participant in the syndicate, including the lead bank, records its own share of the participated loan. Consequently, the recourse issues and contingent liabilities encountered in a loan participation involving syndication are not normally an issue. However, many banks involved in syndicated transactions will sell some of their allotment of the facility through subparticipations. These subparticipations should

be reviewed in the same manner as any other participation arrangement.

## Asset Securitization

Banks have long been involved with asset-backed securities, both as investors in these securities and as sellers of assets within the context of the securitization process. In recent years, banks have increased their participation in the long-established market for those securities that are backed by residential mortgage loans. They have also expanded their securitizing activities to other types of assets, including credit card receivables, automobile loans, boat loans, commercial real estate loans, student loans, nonperforming loans, and lease receivables. See section 4030, "Asset Securitization," for a detailed discussion of the securitization process.

## Risks

Assets sold without recourse are generally not a contingent liability, and the bank should reflect on its books only that portion of the assets it has retained. In some instances, however, participations must be repurchased to facilitate ultimate collection. For example, a bank may sell the portion of a loan that is guaranteed by the Small Business Administration (SBA) and retain the unguaranteed portion and the responsibility for servicing the loan. In the event of a default, the holder of the guaranteed portion has the option to request the originating bank to repurchase its portion before presenting the loan to the SBA for ultimate disposition and collection. In addition, some banks may repurchase assets and absorb any loss even when no legal responsibility exists. It is necessary to determine management's practice in order to evaluate the degree of risk involved. If management routinely repurchases assets that were sold without recourse, a contingency liability should be recognized. The amount of the liability should be based on historical data.

Contingent liabilities may also result if the bank, as the seller of a loan without recourse, does not comply with provisions of the agreement. Noncompliance may result from a number of factors, including failure on the part of the

selling institution to receive collateral and/or security agreements, obtain required guarantees, or notify the purchasing party of default or adverse financial performance by the borrower. The purchaser of a loan may also assert claims that the financial information, which the purchaser relied on when acquiring the loan, was inaccurate, misleading, or fraudulent and that the selling bank was aware of the deficiencies. Therefore, a certain degree of risk may in fact be evident in assets allegedly sold without recourse. Examiners need to be mindful of this possibility and its possible financial consequences on the bank under examination.

Banks also face credit, liquidity, and interest-rate risk in the period in which they accumulate the assets for sale. Especially in mortgage banking activities, the need to carefully monitor interest-rate risk in the "pipeline" represents one of the significant risks of the business. Sellers of participations also face counterparty risk similar to that of a funding desk, because the loan-sales operation depends on the ongoing willingness of purchasers to roll over existing participations and to buy new ones. In addition, many banks sell loans in the secondary market but retain the responsibility for servicing the loans.

## Accounting Issues

For regulatory reporting purposes, some transactions involving the "sale" of assets must be reported as financing transactions (that is, as borrowings secured by the assets "sold"), and others must be reported as sales of the assets involved. The treatment required for any particular transfer of assets depends on whether the "seller" retains risk in connection with the transfer of the assets. In general, to report the transfer of assets as a sale, the selling institution must retain no risk of loss or obligation for payment of principal or interest.

All recourse arrangements should be documented in writing. If a loan is sold with recourse back to the seller, the selling bank has, in effect, retained the full credit risk of the loan, and its lending limit to the borrower is not reduced by the amount sold. Loans sold with recourse are to be treated as borrowings of the selling bank from the purchasing bank. Examiners should consider asset sales subject to formal or informal repurchase agreements (or understandings)

to be sales “with recourse” regardless of other wording in the agreement to the contrary.

In determining the true recourse nature of an asset sale, examiners must determine the extent to which the credit risk has been transferred from the seller to the purchaser. In general, if the risk of loss or obligation for payments of principal or interest is retained by, or may ultimately fall back upon, the seller or lead bank, the transaction must be reported by the seller as a borrowing from the purchaser and by the purchaser as a loan to the seller. Complete details on the treatment of asset sales for purposes of the report of condition and income are found in the glossary of the Instructions for the Preparation of the Report of Condition and Income under the entry “sales of assets.”

## OTHER OFF-BALANCE-SHEET ACTIVITIES AND CONTINGENT LIABILITIES

Banks often provide a large number of customer services, which normally do not result in transactions subject to entry on the general ledger. These customer services include safekeeping, the rental of safe deposit boxes, the purchase and sale of investments for customers, the sale of traveler’s checks, the sale of U.S. Savings Bonds, collection services, federal funds sold as agent, operating leases, and correspondent bank services. It is the bank’s responsibility to ensure that collateral and other nonledger items are properly recorded and protected by effective custodial controls. Proper insurance must also be obtained to protect against claims arising

from mishandling, negligence, mysterious disappearance, or other unforeseen occurrences. Failure to take these protective steps may lead to contingent liabilities. In addition, pending litigation in which the bank is a defendant could expose the bank to substantial risk of loss. Refer to section 4000, “Other Examination Areas,” in this manual for further information.

Banks often enter into operating leases as lessees of buildings and equipment. The arrangements should be governed by a written lease. For a material lease, the examiner must determine whether the lease is truly an operating lease or if it is a capitalized lease pursuant to FASB 13. Capitalized leases and associated obligations must be recorded on the books of the bank in accordance with FASB 13 and the instructions for the preparation of the Report of Condition and Income. Refer to the instructions for the call report and to section 2190, “Bank Premises and Equipment,” in this manual for further information about capitalized leases.

While operating leases do not affect the bank’s capital ratios, the costs of an operating lease may have a material effect upon the earnings of the bank. Moreover, operating leases may involve other responsibilities for the bank, and the bank’s failure to perform these responsibilities may ultimately result in litigation and loss to the bank. The examiner must be cognizant of the requirements imposed on the bank by its leasing arrangements.

Some banks purchase federal funds from smaller correspondent banks as agent. This off-balance-sheet activity is more fully discussed in section 2030, “Bank Dealer Activities,” in this manual.



# Contingent Claims from Off-Balance-Sheet Credit Activities

## Examination Objectives

Effective date November 1995

Section 4110.2

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1. To determine if policies, practices, procedures, and internal controls regarding contingent claims from off-balance-sheet credit activities are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the off-balance-sheet credit activities for credit quality and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

### INTRODUCTION

To meet competitive pressures, banks provide a large number of customer services that normally do not result in assets and liabilities subject to entry on the general ledger, but that may involve significant risk. These customer services include fiduciary accounts, investment management, customer safekeeping, rental of safe deposit box facilities, purchase and sale of investments for customers, sale of traveler's checks, and collection department services. The bank is responsible for properly maintaining and safeguarding all consigned items. Banks accomplish the necessary control and review of consigned and collection items through non-ledger control or memorandum accounts. Automated systems, such as a Securities Movements Accounting and Control system (SMAC), can provide proper control for fiduciary, customer safekeeping, custodial, and investment management accounts.

### CUSTOMER SAFEKEEPING

#### Custodial and Investment Management Accounts

Banks may act as custodians for customers' investments such as stocks, bonds, or gold. Custodial responsibilities may involve simple physical storage of the investments, as well as recording sales, purchases, dividends, and interest.<sup>1</sup> On the other hand, responsibilities may be expanded to include actually managing the account. This type of account management includes advising customers when to sell or buy certain investments, as well as meeting their recording requirements. In addition, the bank may lend securities from custodial accounts if authorized by the customer. This transaction allows the bank, as custodian, to charge a fee for lending the securities, thereby reducing its net custody costs. Also, both the bank and the

custodial account benefit from interest earned on the transaction. This type of transaction should be governed by a policy that clearly specifies quality and maturity parameters. Additionally, to prevent defaults, borrowers should be subject to minimum credit standards, ongoing financial monitoring, and aggregate borrowing limits. Banks may also indemnify customer accounts against losses from a borrower or collateral default. Such indemnification creates a contingent financial risk to the institution.

Before providing such management and/or lending services, the bank should seek the advice of legal counsel about applicable state and federal laws concerning that type of bank-customer relationship. In addition, the use of signed agreements or contracts that clearly define the services to be performed by the bank is a vitally important first step in limiting the bank's potential liability and risk. The bank must also ensure that a proper control environment, including joint custody and access procedures, is established and maintained in support of custodial and management activities. Clearly, the largest and most active companies take on an increased level of risk. For companies that are aggressively pursuing custodial services or other nontraditional lines of business, the examiner should consider an expanded scope of review for these activities.

#### Safe Deposit Boxes

When banks maintain safe deposit box facilities, the bank and the customer enter into a contract whereby the bank receives a fee for renting safe deposit boxes. The bank assumes the responsibility of exercising reasonable care and precaution against loss of the box's contents. When a loss does occur, unless the bank can demonstrate it has maintained the required standard of care, it could be held liable for the loss. The required standard of care is defined as that which would be taken by a reasonably prudent and careful person engaged in the same business. Two different keys are required to open the box, and the customer and the bank each have one. Careful verification of a customer's identification is critical to meeting an appropriate standard of care. The customer is not required to disclose the contents of the box to the bank and

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1. Collection of interest and dividend income cannot be facilitated by the bank where the securities held are still in the customer's name, unless the paying agent is advised to change the dividend/interest address. Typically, when securities remain in the registered name of the holder, the holder continues to receive the dividend/interest payments. If the securities are re-registered into the name of the bank (or its nominee), then dividends and interest are received by the bank for the credit of the custodial customer.

upon court order the bank may gain access to the box without the presence of the customer.

## Safekeeping

In addition to items held as collateral for loans, banks occasionally hold customers' valuables for short periods of time. The bank may or may not charge a fee for the service. Although it is a convenience for bank customers, many banks attempt to discourage the practice by emphasizing the benefits of a safe deposit box. When it is not possible or practical to discourage a customer, the same procedures that are employed in handling collateral must be followed. Items to be stored should be inventoried by two persons and maintained under dual control in the bank's vault. A multicopy, prenumbered, safekeeping receipt should be prepared with a detailed description of the items accepted and it should be signed by the customer. Sealed packages with contents unknown to the bank should never be accepted for safekeeping.

## COLLECTION ITEMS

The collection department is one of the most diversified areas in the bank. It engages in receiving, collecting, and liquidating items which generally require special handling and for which credit normally is given only after final payment is received. The bank acts as agent for its customers or correspondents and receives a fee for that service. Even though general ledger accounts rarely are used in the collection process, the importance and value of customer assets under bank control demand the use of accounting procedures adequate to provide a step-by-step historical summary of each item processed. An audit trail must be developed to substantiate the proper handling of all items and to reduce the bank's potential liability.

## CONSIGNED ITEMS

The most common items held on consignment by banks are unissued traveler's checks and gold. Traveler's checks have gained widespread popularity because of the possibility that cus-

tomers can obtain a refund if the checks are lost or stolen. Traveler's checks are issued for a fee or commission shared by the consignor and the issuing bank. Generally, a working supply of the checks is maintained at the teller line or selling station and a reserve supply is maintained under dual control in the bank's vault.

Under paragraph 7 of section 5136 of the Revised Statutes, national banks may exercise their powers "by buying and selling exchange, coin and bullion." This statute is applied to state member banks under section 9, paragraph 20, of the Federal Reserve Act. Consequently, banks may deal only in gold or silver that qualifies as coin or bullion. The term "coin" means coins minted by a government or exact restrikes, minted at a later date by, or under the authority of, the issuing government. The restrictions contained in the Glass-Steagall Act, which prohibit investment in or underwriting of securities, also are applicable to securities of companies involved with gold.

Rarely does a bank receive sufficient revenues from the above transactions to cover the cost of handling them. However, banks must offer a full range of services to be competitive and attract customers. The bank assumes the responsibility and related contingent liability to properly maintain the assets of others and to properly record all transactions involved with the consigned items.

## INTERNAL CONTROL CONSIDERATIONS

It is essential that bank policy provides for proper internal controls, operating procedures, and safeguards. In all cases, control totals must be generated and the function balanced periodically by someone not associated with the function. Proper insurance protection must also be obtained to protect against claims arising from mishandling, negligence, mysterious disappearance, or other unforeseen occurrences. If an employee should, by fraud or negligence, permit unauthorized removal of items held for safekeeping or issue traveler's checks improperly, the bank may be held liable for losses. Therefore, banks should maintain adequate bonding for contingent liabilities and the examiner should review applicable insurance policies.

# Other Non-Ledger Control Accounts

## Examination Objectives

Effective date May 1996

## Section 4120.2

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1. To determine if the policies, practices, procedures, and internal controls regarding custodial activities, consigned items, and other non-ledger control accounts are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To determine compliance with laws and regulations.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

# Other Non-Ledger Control Accounts

## Examination Procedures

Effective date March 1984

## Section 4120.3

1. If selected for implementation, complete or update the Consigned Items and Other Non-Ledger Control Accounts section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control" and determine if appropriate corrections have been made.
4. Obtain a listing of consigned items and other non-ledger control accounts from the bank.
5. Scan any existing control accounts for any significant fluctuations and determine the cause of fluctuations.
6. Compare bank control records to remittance records for unissued U.S. savings bonds and food stamps.
7. Determine compliance with laws and regulations pertaining to non-ledger control accounts by determining, through observation and discussion with management, that there exist no violation of the prohibition against a bank participating in lotteries (section 9A of the Federal Reserve Act (12 USC 25A)).
8. Prepare in appropriate report form, and discuss with appropriate officer(s):
  - a. Violations of laws and regulations.
  - b. Recommended corrective action when policies, practices or procedures are deficient.
9. Update the workpapers with any information that will facilitate future examinations.

# Other Non-Ledger Control Accounts

## Internal Control Questionnaire

Effective date March 1984

## Section 4120.4

Review the bank's internal controls, policies, practices and procedures for consigned items and other non-ledger items. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### SAFE DEPOSIT BOXES

1. Has counsel reviewed and approved the lease contract in use which covers the rental, use and termination of safe deposit boxes?
- \*2. Is a signed lease contract on file for each safe deposit box in use?
3. Are receipts for keys to the safe deposit box obtained?
4. Are officers or employees of the bank prohibited from acting as a deputy or having the right of access to safe deposit boxes except their own or one rented in the name of a member of their family?
5. Is the guard key to safe deposit boxes maintained under absolute bank control?
6. Does the bank refuse to hold, for renters, any safe deposit box keys?
7. Is each admittance slip signed in the presence of the safe deposit clerk and the time and date of entry noted?
8. Are admittance slips filed numerically?
9. Are vault records noted for joint tenancies and co-rental contracts requiring the presence of two or more persons at each access?
10. Are the safe deposit boxes locked closed when permitting access and the renter's key removed and returned to the customer?
11. Is the safe deposit clerk prohibited from assisting the customer in looking through the contents of a box?
12. Does the safe deposit clerk witness the relocking of the box?
13. Are all coupon booths examined by an attendant after being used but before being assigned to another renter, to be sure the

- previous person did not leave behind anything of value?
14. Has a standard fee schedule for this service been adopted?
  15. Are all collections of rental income recorded when received?
  16. Are all safe deposit boxes where lessee is delinquent in rent, flagged or otherwise marked so that access will be withheld until rent is paid?
  17. Is there a file maintained of all attachments, notices of bankruptcy, letters of guardianship and letters testamentary served on the bank?
  18. Is an acknowledgment of receipt of all property, and a release of liability signed upon termination of occupancy?
  19. Are locks changed when boxes are surrendered, whether or not keys are lost?
  20. Is drilling of boxes witnessed by two individuals?
  21. Are the contents of drilled boxes inventoried, packaged, and placed under dual control?
  - \*22. Are all extra locks and keys maintained under dual control?

### Conclusion

23. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
24. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

### ITEMS IN SAFEKEEPING

- \*25. Are such items segregated from bank-owned assets and maintained under dual control?
26. Is there a set charge or schedule of charges for this service?

27. Do bank policies prohibit holding items in safekeeping free of charge?
28. Are duplicate receipts issued to customers for items deposited in safekeeping?
29. Are the receipts prenumbered?
- \*30. Is a safekeeping register maintained to show details of all items for each customer?
- \*31. Is a record maintained of all entries to custodial boxes or vaults?
32. Does the bank refuse to accept sealed packages when the contents are unknown?
33. If the bank has accepted sealed packages for safekeeping, the contents of which are not described, has the approval of the bank's counsel been obtained?
34. When safekeeping items are released, are receipts obtained from the customer?
42. Are all orders for the purchase and sale of investments properly authorized in the account contract or signed by customers?
43. For coupon securities held by the bank:
  - a. Is a tickler file or other similar system used to ensure prompt coupon redemption on accounts where the bank has been authorized to perform that service?
  - b. Are procedures in effect to prevent clipping of coupons where bank is not so authorized?
  - c. Have procedures been adopted to insure prompt customer credit when coupon proceeds or other payments are received?
- \*44. Are all investment items handled in this area maintained under dual control?

45. Have procedures been established for withdrawal and transmittal of items to customers?
- \*46. Does an officer review and approve all withdrawals prior to the transaction?
47. Has a standard fee schedule for this service been adopted?

### Conclusion

35. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
36. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

### Conclusion

48. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
49. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

## CUSTODIAN ACCOUNTS

(Omit this section if the bank's trust department handles such accounts).

- \*37. Does the bank have written contracts on hand for each account that clearly define the functions to be performed by the bank?
38. Has bank counsel reviewed and approved the type and content of the contracts being used?
39. Does the bank give customers duplicate receipts with detailed descriptions, including dates of coupons attached, if applicable, for all items accepted?
40. Are those receipts prenumbered?
41. Do bank procedures prohibit its holding any investments not covered by a sale or purchase order in this department?

## COLLECTION ITEMS

50. Is access to the collection area controlled (if so, indicate how)?
- \*51. Are permanent registers kept for incoming and outgoing collection items?
52. Are all collections indexed in the collection register?
53. Do such registers furnish a complete history of the origin and final disposition of each collection item?

54. Are receipts issued to customers for all items received for collection?
55. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?
- \*56. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collection items?
57. Is a record kept to show the various collection items which have been paid and credited as a part of the day's business?
58. Is an itemized daily summary made of all collection fees, showing collection numbers and amounts?
59. Are employees handling collection items periodically rotated, without advance notification, to other banking duties?
- \*60. Is the employee handling collection items required to make settlement with the customer on the same business day that payment of the item is received?
61. Does the bank have an established policy of not allowing the customer credit until final payment is received?
- \*62. Have procedures been established, including supervision by an officer, for sending tracers and inquiries on unpaid collection items in the hands of correspondents?
63. In the event of nonpayment of a collection item, is the customer notified and the item promptly returned?
- \*64. Are the files of notes entered for collection clearly and distinctly segregated from bank-owned loans and discounts?
- \*65. Are collection notes above maintained under memorandum control and is the control balanced regularly?
66. Are collection files locked when the employee handling such items is absent?
67. Are vault storage facilities provided for collection items carried over to the next day's business?
- \*68. Does the collection teller turn over all cash to the paying teller at the close of business each day and start each day with a standard change fund?
69. Has a standard fee schedule for this service been adopted?
70. Is the fee schedule always followed?
71. Is a permanent record maintained for registered mailed?

## Conclusion

72. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
73. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

## CONSIGNED ITEMS

- \*74. Is the reserve stock of consigned items maintained under dual control?
75. Are working supplies kept to a reasonable minimum, i.e., two or three days' supply, and adequately protected during banking hours?
- \*76. Is a memorandum control maintained of consigned items?
77. Are separate accounts with the consignor maintained at each issuing location (branch), if applicable?
- \*78. Is the working supply put in the vault at night and over weekends or holidays or is it otherwise protected?
79. Are remittances for sales made on a regularly scheduled basis, if not daily?

## Conclusion

80. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
81. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).



# Payment System Risk and Electronic Funds Transfer Activities

## Section 4125.1

Effective date April 2009

Modern economies require an efficient system for transferring funds between financial institutions and between financial institutions and their customers. Banks and other depository institutions use payment systems both to transfer funds related to their own operations—for example, when engaging in federal-funds transactions—and to transfer funds on behalf of their customers. Depository institutions and the Federal Reserve together provide the basic infrastructure for the nation’s payment system.

Commercial banks maintain accounts with each other and with the Federal Reserve Banks; through these accounts, the payments of the general public are recorded and ultimately settled. The demand for electronic funds transfer (EFT) services has increased with improved data communication and computer technology. Community banks that previously executed EFT transactions through a correspondent can now initiate their own same-day settlement transactions nationwide. The need for same-day settlement transactions has precipitated financial institutions’ increased reliance on EFT systems. Financial institutions commonly use their EFT operations to make and receive payments, buy and sell securities, and transmit payment instructions to correspondent banks worldwide. In the United States, most of the dollar value of all funds transfers is concentrated in two electronic payment systems: the Fedwire Funds Service, which is a real-time gross settlement system provided by the Federal Reserve Banks, and the Clearing House Interbank Payments System (CHIPS), which is a private-sector multilateral settlement system owned and operated by the Clearing House Payments Company.

Final settlement occurs when payment obligations between payment-system participants are extinguished with unconditional and irrevocable funds. For transactions settled in physical currency, payment and settlement finality occur simultaneously. On occasion, settlement finality may not occur on the same day a payment is made. Without immediate settlement finality, the recipient of a payment faces the uncertainty of not receiving the value of funds that has been promised. The exposure to this uncertainty is generally referred to as *payment system risk* (PSR).

Payment system risk refers to the risk of financial loss to the participants in, and operators of, payment systems due to a variety of

exposures, such as counterparty or customer default, operational problems, fraud, or legal uncertainty about the finality of settled payments. A major source of payment system risk arises when participants in, or the operator of, a payment system extends unsecured, intraday credit to facilitate the smooth and efficient flow of payments. For example, the aggregate value of intraday credit extended by the Federal Reserve, in the form of daylight overdrafts in institutions’ Federal Reserve accounts, is substantial and creates significant credit exposure for the Federal Reserve Banks.

A daylight overdraft occurs whenever an institution has a negative account balance during the business day. Such a credit exposure can occur in an account that an institution maintains with a Federal Reserve Bank or with a private-sector financial institution. At a Reserve Bank, a daylight overdraft occurs when an institution has insufficient funds in its Federal Reserve account to cover Fedwire funds transfers, incoming book-entry securities transfers, or other payment activity processed by the Reserve Bank, such as automated clearinghouse or check transactions. Similarly, banks are exposed to credit risk when they permit their customers to incur daylight overdrafts in their accounts. More specific information about the types of risks involved under the rubric of payment systems risk is discussed later in this section.

When developing an institution’s overview, performing annual and quarterly risk assessments, and conducting the institution’s examination, examiners should review an institution’s payment system risk and EFT practices. Supervisory and examination guidance and procedures should be followed to determine the risk assessment, matrix, supervisory plan, and scope of an examination. This guidance should also be used when conducting the examination. An overall initial analysis of an institution’s payment system risk practices can provide examiners with quick insight on the adequacy of its current internal controls and risk-management practices, and on whether the institution’s payment activity creates intraday exposures that may pose significant risk if not managed properly.

In general, examiners should review the frequency, magnitude, and trend of daylight overdrafts in an institution’s Federal Reserve account, as well as any breaches of its net debit cap.

Examiners should analyze the reasons for the daylight overdrafts and cap breaches; the nature of the transactions causing the overdrafts (for example, correspondent check clearings or funds transfers); whether the number of customers, correspondents, and respondents is concentrated among only a few entities; whether there is a clear pattern of transactions; and the types of activities involved. In addition, examiners should review and determine the adequacy of the resolution by the board of directors authorizing the institution's net debit cap and use of Federal Reserve intraday credit (as required by the PSR policy). The examiners' most important goal is to ensure that banks have and use appropriate risk-management policies and procedures that effectively monitor and control their exposure to payment system risk.

## TYPES OF PAYMENT SYSTEMS

An understanding of the mechanics of the various payment systems is necessary to evaluate the operational procedures depository institutions use to control payment-processing risks for their own or their customers' accounts.

### Funds Transfer Systems

#### *Fedwire Funds Service*

The Fedwire funds-transfer system is a real-time gross settlement system in which depository institutions initiate funds transfers that are immediate, final, and irrevocable when processed. Depository institutions that maintain a master account with a Federal Reserve Bank may use Fedwire to directly send or receive payments to, or receive payments from, other account holders directly. Depository institutions use Fedwire to handle large-value and time-critical payments, such as payments for the settlement of interbank purchases and sales of federal funds; the purchase, sale, and financing of securities transactions; the disbursement or repayment of loans; and the settlement of real estate transactions.

In the Fedwire funds-transfer system, only the originating financial institution can remove funds from its Federal Reserve account. Originators provide payment instructions to the Federal Reserve either online or offline. Online

participants send instructions through a main-frame or PC connection to Fedwire, and no manual processing by the Federal Reserve Banks is necessary. Offline participants give instructions to the Reserve Banks by telephone. Once the telephone request is authenticated, the Reserve Bank enters the transfer instruction into the Fedwire system for execution. The manual processing required for offline requests makes them more costly; thus, they are suitable only for institutions that have small, infrequent transfers. (For further information, see [www.federalreserve.gov/paymentsystems/](http://www.federalreserve.gov/paymentsystems/))

#### *CHIPS*

The Clearing House Interbank Payments System (CHIPS) is a large-value funds-transfer system for U.S. dollar payments between domestic or foreign banks that have offices located in the United States. CHIPS provides a final intraday settlement system, continuously matching, netting, and settling queued payment orders throughout the business day.

All CHIPS payment orders are settled against positive balances and are simultaneously offset by incoming payment orders, or some combination of both. To facilitate this process, the funding participants jointly maintain an account (CHIPS account) on the books of the Federal Reserve Bank of New York. Each CHIPS participant must fund this account via a Fedwire funds transfer to fulfill its pre-funded opening-position requirement. These required balances are then used to settle payment orders throughout the day.

During the operating day, participants submit payment orders to a centralized queue maintained by CHIPS. Payment orders that do not pass certain settlement conditions are held in the central queue until an opportunity for settlement occurs or until the end-of-day settlement process. The sending and receiving participants are not obligated to settle these queued payment orders.

Each afternoon, each participant with a closing-position requirement must transfer, through Fedwire, its requirement to the CHIPS account at the Federal Reserve Bank of New York.<sup>1</sup> These requirements, when delivered, are credited to participants' balances at CHIPS.

1. Although CHIPS no longer makes distinctions between settling and nonsettling participants, CHIPS participants can use nostro banks to make transfers on their behalf.

After completion of this process, CHIPS will transfer to those participants who have any balances remaining, that is, participants in an overall net positive position for the day, the full amount of those positions. (For further information, see the CHIPS rules at [www.chips.org](http://www.chips.org).)

## Manual Systems

Not all financial institutions employ an EFT system. Some banks execute such a small number of EFT transactions that the cost of a computer-based system such as Fedwire is prohibitive. Instead, these banks will continue to execute EFTs by a telephone call to a correspondent bank. Executing EFT transactions in this way is an acceptable practice as long as the bank has adequate internal control procedures.

## Message Systems

The message systems employed by financial institutions, corporations, or other organizations to originate payment orders—either for their own benefit or for payment to a third party—are indispensable components of funds-transfer activities. Unlike payment systems, which transmit actual debit and credit entries, message systems process administrative messages and instructions to move funds. The actual movement of the funds is then accomplished by initiating the actual entries to debit the originating customer's account and to credit the beneficiary's account at one or more financial institutions. If the beneficiary's account or the beneficiary bank's account is also with the originator's bank, the transaction is normally handled internally through *book entry*. If the beneficiary-related accounts are outside the originating customer's bank, the transfer may be completed by use of a payment system such as Fedwire or CHIPS. The means of arranging payment orders ranges from manual methods (for example, memos, letters, telephone calls, fax messages, or standing instructions) to electronic methods using telecommunications networks. These networks may include those operated by the private sector, such as SWIFT or Telex, or other networks operated internally by particular financial institutions.

Even though the transfers initiated through systems such as SWIFT and Telex do not result

in the immediate transfer of funds from the issuing bank, they do result in the issuing bank's having an immediate liability, which is payable to the disbursing bank. Therefore, the internal operating controls of these systems should be as stringent as the ones implemented for systems such as Fedwire and CHIPS.

### *SWIFT*

The Society for Worldwide Interbank Financial Telecommunications (SWIFT) is a nonprofit cooperative of member banks that serves as a worldwide interbank telecommunications network for structured financial messaging. Based in Brussels, Belgium, SWIFT is the primary system employed by financial institutions worldwide to transmit either domestic or international payment instructions. (For further information, see [www.swift.com](http://www.swift.com).)

### *TELEX*

Several private telecommunications companies offer worldwide or interconnected services that provide a printed permanent record of each message transmitted. Telex is the primary message system for institutions that do not have access to SWIFT. The Telex systems do not include built-in security features. Telex users exchange security codes, and senders sequentially number messages sent to another institution.

## Automated Clearinghouse and Check Transactions

The automated clearinghouse (ACH) is an electronic payment delivery system used to process low-dollar retail payments. The system is used for preauthorized recurring payments and one-time payments. First introduced in the early 1970s as a more efficient alternative to checks, ACH has evolved into a nationwide mechanism that processes electronically originated credit and debit transfers for any participating institution nationwide. An alternative to paper checks, the ACH handles billions of payments annually.

Financial institutions are encouraged to obtain a copy of the ACH rules of the National Automated Clearing House Association (NACHA): A

*Complete Guide to Rules and Regulations Governing the ACH Network.* The ACH rules provide detailed information on rule changes, their operational impact, and whether any software changes are required. The rulebook is designed to help financial institutions comply with the current NACHA rules, which are applicable to all ACH participants and include a system of national fines. (For further information, see [www.nacha.org](http://www.nacha.org).)

The Federal Reserve ACH is governed by Operating Circular #4, “Automated Clearing House Items.” Other important federal legislation concerning the ACH can be found in Regulation E (primarily regarding consumer rights pertaining to electronic funds transfers) and Regulation CC (concerning the availability of funds). (For further information, see [www.frb services.org](http://www.frb services.org).)

There are two types of ACH transactions: ACH debits and ACH credits. In an ACH debit transaction, the originator of the transaction is debiting the receiver’s account. Therefore, funds flow from the receiver to the originator of the transaction. Mortgage payments for which consumers authorize the mortgage company to debit their accounts each month are examples of ACH debit transactions. ACH debits are also being used increasingly for one-time payments authorized through the telephone, Internet, or mail.

ACH debit transactions have similarities to check transactions. Both receivers of ACH debit files and payers of checks have the right to return transactions for various reasons, such as insufficient funds in the account or a closed account. The major risk facing institutions that originate ACH debit transactions and collect checks for customers is return-item risk. Return-item risk extends from the day funds are made available to the customer until the individual return items are received.

In an ACH credit transaction, the originator of the transaction is crediting the receiver’s account. An ACH credit transaction is similar to Fedwire funds transfers in that funds flow from the originator of the transaction to the receiver. A company payroll payment to its employee would be an example of an ACH credit transaction: the bank sending payments on behalf of a customer (the employer in this instance) has a binding commitment to settle for the payments when the bank sends them to the ACH operator. Since the ACH is a value-dated mechanism, that is, transactions may be originated one or two days before the specified settlement day, the bank is

exposed to temporal credit risk that may extend from one to three business days, depending on when the customer (the employer) funds the payments it originates. If the customer fails to fund the payments on the settlement day, the potential loss faced by the originating bank is equal to the total value of payments from the time the payments are sent to the ACH operator until the customer funds these payments.

## SECURITIES CLEARING AND SETTLEMENT SYSTEMS

### Fedwire Securities

The Fedwire Securities Service is a securities settlement system that provides safekeeping services and transfer and settlement services. The safekeeping services enable eligible participants to hold securities issued by the U.S. Department of the Treasury, federal agencies, government-sponsored enterprises (GSEs), and certain international organizations in securities accounts at the Reserve Banks. The transfer and settlement services enable eligible participants to transfer securities to other eligible participants against payment or free of payment.

Participants in the Fedwire Securities Service generally maintain a master account and have routine access to Reserve Bank intraday credit. Like the Fedwire Funds Service, access to the Fedwire Securities Service is limited to depository institutions and a few other organizations, such as federal agencies, state government treasurers’ offices (which are designated by the U.S. Department of the Treasury to hold securities accounts), and limited-purpose trust companies that are members of the Federal Reserve System. Nonbank brokers and dealers typically hold and transfer their securities through clearing banks, which are Fedwire participants that provide specialized government securities clearing services. (For more information, see [www.federalreserve.gov/paymentsystems/](http://www.federalreserve.gov/paymentsystems/))

Securities transfers can be made free of payment or against a designated payment. Most securities transfers involve the delivery of securities and the simultaneous exchange of payment for the securities, a transaction called delivery-versus-payment. The transfer of securities and related funds (if any) is final at the time of transfer.

### *Transfer-Size Limit on Book-Entry Securities*

Secondary-market book-entry securities transfers on Fedwire are limited to a transfer size of \$50 million par value. This limit is intended to encourage partial deliveries of large trades in order to reduce position building by dealers, a major cause of book-entry securities overdrafts before the introduction of the transfer-size limit and daylight-overdraft fees. This limitation does not apply to—

- original-issue deliveries of book-entry securities from a Reserve Bank to an institution, or
- transactions sent to or by a Reserve Bank in its capacity as fiscal agent of the United States, government agencies, or international organizations.

Thus, requests to strip or reconstitute Treasury securities or to convert bearer or registered securities to or from book-entry form are exempt from this limitation. Also exempt are pledges of securities to a Reserve Bank as principal (for example, discount window collateral) or as agent (for example, Treasury Tax and Loan collateral).

### Private Systems

In addition to U.S. Treasury and government-agency securities, major categories of financial instruments commonly traded in the United States include corporate equities and bonds, municipal (state and local) government securities, money market instruments, and derivatives such as swaps and exchange-traded options and futures. These instruments are generally traded through recognized exchanges or over-the-counter dealer markets. The mechanisms for clearance and settlement vary by type of instrument and generally involve specialized financial intermediaries, such as clearing corporations and depositories. Clearing corporations provide trade comparison and multilateral netting of trade obligations. Securities depositories, in contrast, hold physical securities and provide book-entry transfer and settlement services for their members.

The vast majority of corporate equity and bond trades are cleared through the National Securities Clearing Corporation (NSCC). Most corporate securities, as well as municipal gov-

ernment bonds, are held at the Depository Trust Company (DTC) in New York. Settlement of securities cleared through the NSCC is effected by book-entry transfers at the DTC. The DTC and the NSCC are owned by the Depository Trust and Clearing Corporation, an industry-owned holding company. (For more information, see [www.dtcc.com](http://www.dtcc.com).)

U.S. Treasury, federal-agency, and mortgage-backed securities are generally traded in over-the-counter markets. The Fixed Income Clearing Corporation (FICC) compares and nets its members' trades in most U.S. Treasury and federal-agency securities. The FICC relies on the Fedwire securities service, discussed above, to effect final delivery of securities to its participants. The FICC is owned by the DTCC. (For more information see [www.dtcc.com](http://www.dtcc.com).)

The FICC also provides automated post-trade comparison, netting, risk-management, and pool-notification services to the mortgage-backed securities market. The FICC provides its specialized services to major market participants active in various Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC), and Federal National Mortgage Association (Fannie Mae or FNMA) mortgage-backed securities programs. The net settlement obligations of FICC participants are settled through the Fedwire book-entry securities system.

## POLICY ON PAYMENT SYSTEM RISK

The Federal Reserve's Policy on Payment System Risk (the PSR policy) addresses in part, the risks that payment and securities settlement systems present to the Federal Reserve Banks, the banking system, and other sectors of the economy. Part II of the PSR policy focuses on institutions'<sup>2</sup> use of Federal Reserve intraday credit.<sup>3</sup> An integral component of the PSR

2. The PSR policy uses the term *institutions*, which refers to depository institutions, U.S. branches and agencies of foreign banking organizations, Edge and agreement corporations, bankers' banks, limited-purpose trust companies, government-sponsored enterprises, and international organizations, unless the context indicates a different meaning.

3. Part I of the PSR policy addresses risks in private-sector payment systems and settlement. The full text of the PSR policy is available at [www.federalreserve.gov/paymentsystems/psr\\_policy.htm](http://www.federalreserve.gov/paymentsystems/psr_policy.htm).

policy is a program to control the risks in the payment system, including institutions' use of Federal Reserve intraday credit, commonly referred to as *daylight credit* or *daylight overdrafts*. Individual Reserve Banks are responsible for administering the Board's PSR policy and ensuring compliance by institutions. A primary objective of examiners when evaluating payment system risk is to ensure that banks using Federal Reserve payment services comply with the Board's PSR policy.

## PSR Policy Objectives

Like institutions that offer payment services to customers, Federal Reserve Banks encounter credit risk when they process payments for institutions that hold accounts with them. The Federal Reserve guarantees settlement on Fedwire funds and book-entry securities transfers, net settlement service (NSS) entries,<sup>4</sup> and ACH credit originations made by account holders. If an institution were to fail after sending a transaction that placed its account in an overdraft position, the Federal Reserve would be obligated to cover the payment and bear any resulting losses. Risk is present even when an institution overdraws its account at a Reserve Bank for only a few minutes during the day.

Similar types of risk are generated when customers of private financial institutions and participants in some private-sector payment arrangements incur daylight overdrafts. In addition, daylight credit may be a source of systemic risk in the payment system. *Systemic risk* refers to the potential that the failure of one participant in a payment system, or in the financial markets generally, to meet its required obligations will cause other participants or financial institutions to be unable to meet their settlement obligations when due.

The PSR policy allows Reserve Banks to mitigate their credit risk in several ways. For instance, institutions that access daylight credit must satisfy safety-and-soundness requirements. In addition, the policy permits Reserve Banks to protect themselves from risk exposure of individual institutions through such measures as restricting account activity or imposing collateral requirements.

The PSR policy establishes limits on the

maximum amount of Federal Reserve daylight credit that an institution may use during a single day or over a two-week period. These limits are sufficiently flexible to reflect the overall financial condition and operational capacity of each institution using Federal Reserve payment services. The policy also permits Reserve Banks to protect themselves from the risk of loss through measures such as reducing net debit caps; imposing collateralization or clearing-balance requirements; and rejecting certain transactions during the day until balances are available in its Federal Reserve account; or, in extreme cases, taking the institution offline or prohibiting it from using Fedwire.

## FEDERAL RESERVE INTRADAY CREDIT POLICIES (PART II)

In December 2008, the Board adopted major revisions to part II of the PSR policy that are designed to improve intraday liquidity management and payment flows for the banking system, while also helping to mitigate the credit exposures of the Federal Reserve Banks.<sup>5</sup> The changes included an approach that explicitly recognizes the role of the central bank in providing intraday balances and credit to healthy depository institutions. In addition, the Board revised other elements of the PSR policy dealing with daylight overdrafts, which included adjusting net debit caps, voluntary collateralization of intraday credit, a limit on total daylight overdrafts in institutions' Federal Reserve accounts, and eliminating the current deductible for daylight overdraft fees.

The Board also approved for certain foreign banking organizations a policy change related to the calculation of the deductible amount from daylight overdraft fees and early implementation of the streamlined procedure for maximum daylight overdraft capacity (max cap). The policy changes and the early implementation of the streamlined max cap became effective on March 26, 2009.

## Daylight-Overdraft Capacity

Under the Federal Reserve's PSR policy, each

4. The Federal Reserve's NSS provides settlement services to various clearinghouses.

5. See Board's press release at [www.federalreserve.gov/newsevents/press/other/20081219a.htm](http://www.federalreserve.gov/newsevents/press/other/20081219a.htm).

Table 1—Net debit cap multiples

Cap categories	Net debit cap multiples	
	Single-day	Two-week average
High	2.25	1.50
Above average	1.875	1.125
Average	1.125	0.75
De minimis	0.40	0.40
Exempt-from-filing*	\$10 million or 0.20	\$10 million or 0.20
Zero	0	0

\* The net debit cap for the exempt-from-filing category is equal to the lesser of \$10 million or 0.20 multiplied by the institution's capital measure.

institution that maintains an account at a Federal Reserve Bank is assigned or may establish a net debit cap, as outlined below. The net debit cap limits the amount of intraday Federal Reserve credit that the institution may use during a given interval. The policy allows financially healthy institutions that have regular access to the discount window to incur daylight overdrafts in their Federal Reserve accounts up to their individual net debit caps. In addition, the policy allows certain institutions to pledge collateral to the Federal Reserve to access additional daylight-overdraft capacity above their net debit caps. In these instances, the institution can incur daylight overdrafts equaling the lesser of its net debit cap and pledged collateral or max cap if it is fully collateralized.

## NET DEBIT CAPS

An institution's net debit cap refers to the maximum dollar amount of uncollateralized daylight overdrafts that the institution may incur in its Federal Reserve account. An institution's cap category and its capital measure determine the dollar amount of its net debit cap.<sup>6</sup> An institution's net debit cap is calculated as its cap

multiple, as listed in table 1, times its capital measure:

$$\text{net debit cap} = \text{cap multiple} \times \text{capital measure}$$

Because a net debit cap is a function of an institution's capital measure, the dollar amount of the cap will vary over time as the institution's capital measure changes. Unless circumstances warrant a revision, an institution's cap category, however, is normally fixed over a one-year period. Cap categories and their associated cap levels, set as multiples of capital, are listed in table 1.

An institution is expected to avoid incurring daylight overdrafts whose daily maximum level, averaged over a two-week period, would exceed its two-week average cap, and, on any day, would exceed its single-day cap. The two-week average cap provides flexibility, recognizing that fluctuations in payments can occur from day to day. The purpose of the single-day cap is to limit excessive daylight overdrafts on any day and to ensure that institutions develop internal controls that focus on the exposures each day, as well as over time. Institutions in the zero, exempt-from-filing, and de minimis cap categories have one cap that applies to both the single-day peak overdraft and the average overdraft for a two-week period.

The Board's policy on net debit caps is based on a specific set of guidelines and some degree of examiner oversight. Under the Board's policy, a Reserve Bank may limit or prohibit an institution's use of Federal Reserve intraday

6. The capital measure used in calculating an institution's net debit cap depends on its home-country supervisor and chartering authority. For institutions chartered in the United States, net debit caps are multiples of "qualifying" or similar capital measures, that is, those capital instruments that can be used to satisfy risk-based capital standards, as set forth in the capital adequacy guidelines of the federal financial institution regulatory agencies.

credit if (1) the institution's use of daylight credit is deemed by the institution's supervisor to be unsafe or unsound, (2) the institution does not qualify for a positive net debit cap (see section II.C.2., "Cap Categories," of the PSR policy), or (3) the institution poses excessive risk to a Reserve Bank by incurring chronic overdrafts in excess of what the Reserve Bank determines is prudent.

## Cap Categories

The PSR policy defines six cap categories: high, above average, average, de minimis, exempt-from-filing, and zero. The high, above-average, and average cap categories are referred to as "self-assessed" caps.

### *Self-Assessed*

To establish a net debit cap category of high, above-average, or average, an institution must perform a self-assessment of its creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures. The assessment of creditworthiness is based on the institution's supervisory rating and prompt-corrective-action designation. An institution may be required to perform a full assessment of its creditworthiness in certain limited circumstances, for example, if its condition has changed significantly since the last examination. An institution performing a self-assessment must also evaluate its intraday funds-management procedures and its procedures for evaluating the financial condition of, and establishing intraday credit limits for, its customers. Finally, the institution must evaluate its operating controls and contingency procedures to determine if they are sufficient to prevent losses due to fraud or system failures.

An examiner's review of an institution's assessment is an important part of determining the institution's compliance with the PSR policy. An examiner is responsible for ensuring that the institution has applied the guidelines appropriately and diligently, that the underlying analysis and methodology were reasonable, and that the resulting self-assessment was generally consistent with examination findings. The following discussion is a simplified explanation of the self-assessment factors. A more detailed expla-

nation of the self-assessment process is provided in the *Guide to the Federal Reserve's Payment System Risk Policy*. (The guide is available on the Internet at [www.federalreserve.gov/paymentsystems/psr\\_relpolicies.htm](http://www.federalreserve.gov/paymentsystems/psr_relpolicies.htm).)

*Creditworthiness.* Of the four self-assessment factors, creditworthiness is the most influential in determining an overall net debit cap for a given institution. The creditworthiness factor is principally determined by a combination of the institution's capital adequacy and most recent supervisory rating. In the self-assessment, an institution's creditworthiness is assigned one of the following ratings: excellent, very good, adequate, or below standard. An excellent or a very good rating indicates that an institution demonstrates a sustained level of financial performance above its peer-group norm. As a general matter, fundamentally sound institutions that experience only modest weaknesses receive a rating of very good.

Most institutions will use the creditworthiness matrix to determine this component's rating. If an institution's creditworthiness rating is adequate or better, it then proceeds to rate the other three factors in the self-assessment process. The institution's assessment of the other three factors determines whether its composite rating will be lower than or equal to that determined by the creditworthiness factor. If the overall creditworthiness is below standard, then the institution does not qualify for a positive daylight-overdraft cap. In certain limited circumstances, an institution may conduct a full analysis of this component. The matrix and information regarding the full analysis are available in the *Guide to the Federal Reserve's Payment System Risk Policy*.

*Intraday funds management and control.* The purpose of analyzing intraday funds management and control is to assess an institution's ability to fund its daily settlement obligations across all payment systems in which it participates. The analysis requires a review of funds management, credit, operations personnel, and payment activity over a period of time.

To obtain an accurate understanding of funds movements, an institution must fully understand its daily use of intraday credit as well as its use of intraday credit on average over two-week periods. The analysis should cover a sufficient period of time so that an institution can determine its peak demand for intraday credit and establish its average use of such credit. The



more volatile an institution's payments activity, the longer the interval that is selected for analysis. The analysis incorporates all operational areas with access to payment systems. In addition to large-dollar funds and book-entry securities-transfer activity, the review should address check clearing, ACH, currency operations, and other payment activity that results in relatively large-value settlement obligations. Thus, the analysis should not be limited to online payment systems or to payment systems to which the institution has online access. Additionally, institutions with direct access to Fedwire or to other payment systems in more than one Federal Reserve District must combine all of these access points into a single integrated analysis.

In performing the analysis, the institution considers both liquidity demands and the potential credit risks associated with participation in each payment system. The institution's capacity to settle its obligations in both routine and nonroutine circumstances must be carefully assessed. In many cases, a complete assessment of an institution's ability to control its intraday obligations extends beyond its ability to control its use of Federal Reserve intraday credit within the constraints of its net debit cap. Rather, the assessment extends to the institution's ability to control its position across all payment systems to a level that permits it to fund its obligations regularly. This type of assurance requires an institution to fully understand the nature of its obligations and to establish systems that permit it to monitor daily activity and respond to unusual circumstances.

*Customer credit policies and controls.* The assessment of an institution's customer credit policies and controls requires two distinct analyses:

- an analysis of the institution's policies and procedures for assessing the creditworthiness of its customers, counterparties, and correspondents and
- an analysis of the institution's ability to monitor the positions of individual customers and to control the amount of intraday and interday credit extended to each customer.

The analyses require the involvement of both credit and operations personnel, and both analyses should focus on the creditworthiness of all customers, including corporate and other insti-

tutions that are active users of payment services. In addition, the creditworthiness of correspondents and all counterparties on privately operated clearing and settlement systems must be assessed.

*Operating controls and contingency procedures.*

The purpose of the analysis of operating controls and contingency procedures is to assess the integrity and the reliability of an institution's payment operations to ensure that they are not a source of operating risk. The integrity of operations is of particular concern because operational errors and fraud can increase the cost of payment services and undermine public confidence in the payments mechanism. Similar results can occur if payment systems are unreliable and if parties making and receiving payments do not have confidence that timely payments will be made.

*Overall assessment rating.* Once the four self-assessment components are analyzed and an overall rating is determined, the institution's self-assessment and recommended cap category must be reviewed and approved by the institution's board of directors at least once each 12-month period. A cap determination may be reviewed and approved by the board of directors of a holding company parent of an institution, provided that (1) the self-assessment is performed by each entity incurring daylight overdrafts, (2) the entity's cap is based on the measure of the entity's own capital, and (3) each entity maintains for its primary supervisor's review its own file with supporting documents for its self-assessment and a record of the parent's board-of-directors review. The directors' approval must be communicated to the Reserve Bank by submission of a board-of-directors resolution. The Reserve Bank then reviews the cap resolution for appropriateness, in conjunction with the institution's primary regulator. If the Reserve Bank determines that the cap resolution is not appropriate, the institution is informed that it must re-evaluate its self-assessment and submit another resolution. A resolution to establish a different cap category may be submitted by the institution, or it may be required by the Reserve Bank before the annual renewal date, if circumstances warrant such a change.

### *De Minimis*

Institutions that qualify for a de minimis net debit cap incur relatively small daylight overdrafts and thus pose little risk to the Federal Reserve. To ease the burden of performing a self-assessment for these institutions, the PSR policy allows institutions that meet reasonable safety-and-soundness standards to incur de minimis amounts of daylight overdrafts without performing a self-assessment. Such an institution may incur daylight overdrafts of up to 40 percent of their capital measure if it submits a board-of-directors resolution.

An institution with a de minimis cap must submit to its Reserve Bank at least once in each 12-month period a copy of its board-of-directors resolution (or a resolution by its holding company's board) approving the institution's use of daylight credit up to the de minimis level. If an institution with a de minimis cap exceeds its cap during a two-week reserve-maintenance period, its Reserve Bank will decide whether the de minimis cap should be maintained or whether the institution will be required to perform a self-assessment for a higher cap.

### *Exempt-from-Filing*

The majority of institutions that hold Federal Reserve accounts have an exempt-from-filing net debit cap. Granted at the discretion of the Reserve Bank, the exempt-from-filing cap category permits institutions that use small amounts of Federal Reserve daylight credit to incur daylight overdrafts that exceed the lesser of \$10 million or 20 percent of their capital measure. The Reserve Banks will review the status of an exempt institution that incurs overdrafts in its Federal Reserve account in excess of \$10 million or 20 percent of its capital measure on more than two days in any two consecutive two-week reserve-maintenance periods. The Reserve Bank will decide if the exemption should be maintained or if the institution will be required to file for a higher cap. Granting of the exempt-from-filing net debit cap is at the discretion of the Reserve Bank.

### *Zero*

Some financially healthy institutions that could obtain positive net debit caps choose to have zero caps. Often these institutions have very conservative internal policies regarding the use

of Federal Reserve daylight credit, or they simply do not want to incur daylight overdrafts and any associated daylight-overdraft fees. If an institution that has adopted a zero cap incurs a daylight overdraft, the Reserve Bank counsels the institution and may monitor the institution's activity in real time and reject or delay certain transactions that would cause an overdraft. If the institution qualifies for a positive cap, the Reserve Bank may suggest that the institution adopt an exempt-from-filing cap or file for a higher cap, if the institution believes that it will continue to incur daylight overdrafts. In addition, a Reserve Bank may assign an institution a zero net debit cap. Institutions that may pose special risks to the Reserve Banks, such as those institutions without regular access to the discount window, those incurring daylight overdrafts in violation of this policy, or those in weak financial condition, are generally assigned a zero cap. New account holders may also be assigned a zero net debit cap.

### Maximum Daylight Overdraft Capacity (Max Cap)

While net debit caps provide sufficient liquidity to most institutions, some institutions may experience liquidity pressures. Consequently, certain institutions with self-assessed net debit caps may pledge collateral to their administrative Reserve Bank (ARB) to secure daylight-overdraft capacity in excess of their net debit caps, subject to Reserve Bank approval. This policy is intended to provide extra liquidity through the pledge of collateral to the few institutions that might otherwise be constrained from participating in risk-reducing payment system initiatives. Institutions that request daylight-overdraft capacity beyond the net debit cap must have already explored other alternatives to address their increased liquidity needs.<sup>7</sup> An institution that wishes to expand its daylight-overdraft capacity by pledging collateral should consult with its ARB.<sup>8</sup> The ARB will work with

7. Some potential alternatives available to a depository institution to address increased intraday credit needs include (1) shifting funding patterns, (2) delaying the origination of funds transfers in a way that does not significantly increase operational risks, or (3) transferring some payments-processing business to a correspondent bank.

8. The ARB is responsible for the administration of Federal Reserve credit, reserves, and risk-management policies for a given institution or other legal entity.

an institution that requests additional daylight-overdraft capacity to decide on the appropriate max cap level. When considering the institution's request, the Reserve Bank will evaluate the institution's rationale for requesting additional daylight-overdraft capacity as well as its financial and supervisory information. The financial and supervisory information considered may include, but is not limited to, capital and liquidity ratios, the composition of balance-sheet assets, CAMELS or other supervisory ratings and assessments, and SOSA rankings (for U.S. branches and agencies of foreign banks).<sup>9</sup> Institutions are also expected to submit the following information when requesting a max cap level under general procedures:

- the amount of maximum daylight-overdraft capacity requested
- written justification for requesting additional daylight-overdraft capacity
- written approval from the institution's board of directors or, in the case of U.S. branches and agencies of foreign banks, written approval from the bank's most senior officer responsible for formulating policy at the foreign bank's U.S. head office
- a principal contact at the institution

When deciding whether an institution is eligible for collateralized capacity, the ARB will consider the institution's reasons for applying for additional collateralized capacity; the information related to the institution's condition; and other information, as applicable. If the ARB approves the request for a max cap level, the institution must submit a board-of-directors resolution for the max cap level at least once in each 12-month period, indicating its board-of-directors approval of that level. An institution's max cap is defined as follows:

$$\begin{aligned} &\text{maximum daylight-overdraft capacity} \\ &\quad \text{or max cap} = \\ &\text{single-day net debit cap} + \\ &\text{collateralized capacity}^{10} \end{aligned}$$

9. See the full text of the PSR policy to view the streamlined procedures a qualified foreign banking organization may request from its Reserve Bank to obtain a max cap.

10. Collateralized capacity represents the collateralized component of the max cap approved by the Reserve Bank. The amount of collateralized capacity cannot exceed the difference between the institution's max cap level and its net debit cap. For example, if an institution's single-day net debit cap increases as a result of an increase in capital at the institution, its max cap is unchanged, so its collateralized

Institutions with exempt-from-filing and de minimis net debit caps may not obtain additional daylight-overdraft capacity by pledging collateral. These institutions must first obtain a self-assessed net debit cap. Institutions with zero net debit caps also may not obtain additional daylight-overdraft capacity by pledging collateral. If an institution has adopted a zero cap voluntarily, but qualifies for a positive cap, it may not obtain additional daylight-overdraft capacity by pledging collateral without first obtaining a self-assessed net debit cap. Institutions that have been assigned a zero net debit cap by their ARB are not eligible for additional daylight-overdraft capacity.

## ROLE OF DIRECTORS

The directors of an institution establish and implement policies to ensure that its management follows safe and sound operating practices, complies with applicable banking laws, and prudently manages financial risks. Given these responsibilities, the directors play a vital role in the Federal Reserve's efforts to reduce risks within the payment system. As part of the PSR policy, the Federal Reserve requests that directors, at a minimum, undertake the following responsibilities:

- Understand the institution's practices and controls for the risks it assumes when processing large-dollar transactions for both its own account and the accounts of its customers or respondents.
- Establish prudent limits on the daylight overdrafts that the institution incurs in its Federal Reserve account and on its privately operated clearing and settlement systems.
- Periodically review the frequency and dollar levels of daylight overdrafts to ensure that the institution operates within the guidelines established by its board of directors. Directors should be aware that, under the Federal Reserve's PSR policy, repeated policy violations could lead to reductions in the institution's daylight-overdraft capacity, or to the imposition of restrictions on its Federal Reserve account activity, either of which could affect the institution's operations.

capacity is reduced. The institution's overdraft position will be measured against the lesser of (1) its max cap or (2) its net debit cap plus the amount of collateral pledged.

Each institution that performs a self-assessment for a net debit cap should establish daylight-overdraft policies and controls after considering its creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures.

The directors may appoint a committee of directors to focus on the institution's participation in payment systems and its use of daylight credit. Furthermore, a higher-level board of the same corporate family may conduct a self-assessment review, if necessary, and approve a resolution. The board of directors should be aware that delegating the review process to a committee or higher-level board does not absolve the directors from the responsibilities stated in the Federal Reserve's PSR policy. The directors cannot delegate this responsibility to an outside consultant or third-party service provider.

For institutions requesting max caps, the board of directors must understand the use and purposes of the pledged collateral under the PSR policy. The directors must understand the reasons that the institution is applying for additional daylight-overdraft capacity, the amount of the collateralized capacity, and the total amount of the net debit cap plus collateralized capacity.

The Federal Reserve recognizes that directors of foreign banks do not necessarily serve in the same capacity as directors of banks in the United States. Therefore, individuals who are responsible for formulating policy at the foreign bank's head office may substitute for directors in performing the responsibilities specified in the PSR policy.

## Cap Resolutions

A board-of-directors resolution is required to establish a cap in the de minimis or self-assessed cap categories (high, above average, or average). In addition, a separate resolution is required for self-assessed institutions that wish to obtain collateralized capacity above their net debit caps (max cap). These resolutions must follow a prescribed format. Specifically, resolutions must include (1) the official name of the institution, (2) the city and state in which the institution is located, (3) the date the board acted, (4) the cap category adopted, (5) the appropriate official signature, and (6) the ABA routing number of the institution. For a board resolution approving the

results of a self-assessment, the resolution must identify the ratings assigned to each of the four components of the assessment as well as the overall rating used to determine the actual net debit cap. In addition, the institution should indicate if it did not use the creditworthiness-matrix approach in determining its creditworthiness rating.

An institution's primary supervisor may review resolutions, and any information and materials the institution's directors used to fulfill their responsibilities under the PSR policy. They must be made available to the bank supervisor's examiners. Supporting documentation used in determining an appropriate cap category must be maintained at the institution. At a minimum, the following items must be maintained in the institution's "cap resolution file":

- an executed copy of the resolution adopting the net debit cap and/or max cap;
- worksheets and supporting analysis used in its self-assessment of its own cap category;
- for institutions with self-assessed caps, copies of management's self-assessment of creditworthiness, intraday funds management and control, customer credit policies and controls, and operating controls and contingency procedures;
- minutes and other documentation that serve as a formal record of any directors' discussions on the self-assessment and/or request for max cap;
- status reports the board of directors received on the institution's compliance with both the resolutions adopted by the directors and the PSR policy; and
- other materials that provide insight into the directors' involvement in carrying out their responsibilities under the PSR policy, including special studies or presentations made to the directors.

The board-of-directors resolution for de minimis and self-assessed institutions and for collateralized-capacity resolutions is valid for one year after the Reserve Bank approves the net debit cap or the amount of maximum daylight-overdraft capacity. An institution with a de minimis cap must renew its cap resolution annually by submitting a new resolution to its Reserve Bank. An institution with a self-assessed cap must perform a new self-assessment annually and submit an updated cap resolution to its Reserve Bank. An institution that has a

self-assessed cap and has obtained a max cap must submit a board-of-directors resolution to its Reserve Bank annually. Procedures for submitting these resolutions are the same as those for establishing the initial cap; however, an institution may submit a resolution for a different cap category or a different amount of collateralized capacity, if appropriate. The Reserve Bank, in conjunction with an institution's primary supervisor, will review the appropriateness of each resolution.

Because the self-assessment process may, in some cases, require considerable time to complete and approve, institutions should be aware of the expiration date of their cap resolutions well in advance. If a new cap resolution is not received by the expiration date, an institution may be assigned a zero cap, which would generally preclude the institution from using any Federal Reserve daylight credit.

## Confidentiality

The Federal Reserve considers institutions' daylight-overdraft caps; cap categories; and collateralized capacity, if applicable, to be confidential information and will only share this information with an institution's primary supervisor. Institutions are also expected to treat cap and collateralized-capacity information as confidential. Cap and collateralized-capacity information should not be shared with outside parties or mentioned in any public documents.

## DAYLIGHT-OVERDRAFT MONITORING AND CONTROL

All institutions that maintain Federal Reserve accounts and use Federal Reserve Services are expected to monitor their account balances on an intraday basis. Institutions should be aware of payments they are making from their accounts each day and how those payments are funded. Institutions are encouraged to use their own systems and procedures, as well as the available Federal Reserve's systems, to monitor their Federal Reserve account balance and payment activity.

## Daylight-Overdraft Measurement

To determine whether a daylight overdraft has occurred in an institution's account, the Federal Reserve uses a set of transaction-posting rules that define explicitly the time of day that debits and credits for transactions processed by a Reserve Bank will post to the account.<sup>11</sup> All Fedwire funds transfers, book-entry securities transfers, and NSS transactions are posted to an institution's account as they occur throughout the day. Other transactions, including ACH and check transactions, are posted to institutions' accounts according to a defined schedule. These posting rules should help institutions control their use of intraday credit because they allow institutions to monitor the time that each transaction is credited or debited to their account. Note that these posting times affect the calculation of the account balance for daylight-overdraft-monitoring and pricing purposes but do not affect the finality or revocability of the entry to the account. An important feature of the posting rules is a choice of posting times for check credits.

## Monitoring Daylight Overdrafts

To monitor an institution's overdraft activity and its compliance with the PSR policy and to calculate daylight-overdraft charges, the Federal Reserve uses the Daylight-Overdraft Reporting and Pricing System (DORPS). DORPS captures all debits and credits resulting from an institution's payment activity and calculates end-of-minute account balances using the daylight-overdraft posting rules. As measured by DORPS, an institution's account balance is calculated at the end of each minute, based on its opening balance and all payment transactions posted to the institution's account up until that moment. The daylight-overdraft measurement period begins with the current official opening time of

11. Posting rules were last amended on June 20, 2006, when the Board revised its PSR policy (effective July 20, 2006) concerning interest and redemption payments on securities issued by government-sponsored enterprises (GSEs) and certain international organizations. The revised policy requires Reserve Banks to release these interest and redemption payments as directed by the issuer, provided the issuer's Federal Reserve account contains sufficient funds to cover them. Each issuer is required to fund its interest and redemption payments by 4 p.m. eastern time for the payments to be processed that day. For further information on the posting rules, see the PSR policy.

Fedwire and continues until the official closing time. Although DORPS records positive as well as negative account balances, positive balances do not offset negative balances for purposes of determining compliance with net debit caps or for calculating daylight-overdraft fees. In cases of unscheduled extensions of Fedwire hours, the final closing account balance is recorded as if it was the balance at the standard closing time, and balances between the scheduled and actual closing times are not recorded. DORPS generates reports at the end of each two-week reserve-maintenance period.<sup>12</sup> These reports provide useful information for monitoring daylight overdrafts, such as peak daily overdrafts for the period; overdrafts in excess of net debit cap; end-of-minute account balances for a particular day; and related ratios, such as the peak daily overdraft relative to net debit cap.<sup>13</sup>

## Monitoring PSR Policy Compliance

Reserve Banks generally monitor institutions' compliance with the PSR policy over each two-week reserve-maintenance period. In most cases, a policy violation occurs when an institution's account balance for a particular day shows one or more negative end-of-minute account balances in excess of its single-day net debit cap or when an institution's average peak daily overdraft over a reserve-maintenance period exceeds its two-week average cap.<sup>14</sup> The exceptions to this general rule are discussed below.

Institutions in the exempt-from-filing cap category are normally allowed two cap breaches in two consecutive, two-week, reserve-maintenance periods without violating the PSR policy. For institutions in all other cap categories or for institutions that have been approved for maximum daylight-overdraft capacity, each cap breach is considered a policy violation. A Reserve Bank may waive a violation in limited circumstances such as an operational problem at

a Reserve Bank.

An institution with a self-assessed cap that has been approved for maximum daylight-overdraft capacity should avoid incurring daylight overdrafts that, on average over a two-week period, exceed its two-week-average limit, and that, on any day, exceed its single-day limit. The two-week-average limit is equal to the two-week average cap plus the amount of applicable collateralized capacity, averaged over a two-week reserve-maintenance period. The single-day limit is equal to an institution's net debit cap plus the amount of collateralized capacity.

For daylight-overdraft purposes, accounts of U.S. branches and agencies of foreign banks and accounts involved in merger-transitions are monitored on a consolidated basis; that is, a single account balance is derived by adding together the end-of-minute balances of each account. The accounts of affiliated institutions are monitored separately if they are separate legal entities. In addition, for institutions with accounts in more than one Federal Reserve District, an ARB is designated. The ARB coordinates the Federal Reserve's daylight-overdraft monitoring for the consolidated accounts or institutions.

## *Consequences of Violations*

A PSR policy violation may initiate a series of Reserve Bank actions aimed at deterring an institution's excessive use of Federal Reserve intraday credit. These actions depend on the institution's history of daylight overdrafts and its financial condition. Initially, the Reserve Bank may assess the causes of the overdrafts, send a counseling letter to the institution, and review account-management practices. In addition, the Reserve Bank may require an institution to submit documentation specifying the actions it will take to address the overdraft problems. If policy violations continue, the Reserve Bank may take additional actions. For example, if a financially healthy institution in the zero, exempt-from-filing, or de minimis cap category continues to breach its cap, the Reserve Bank may recommend that the institution file a cap resolution or perform a self-assessment to obtain a higher net debit cap.

If an institution continues to violate the PSR policy, and if counseling and other Reserve Bank actions have been ineffective, the Reserve

12. Reserve Banks may make these reports available to institutions to assist in their internal account monitoring and control, and for the assessment of daylight overdraft fees.

13. For further information on the reports see the *Account Management Guide* at [www.frbservices.org/Accounting/pdf/amg.pdf](http://www.frbservices.org/Accounting/pdf/amg.pdf).

14. An institution's average peak daily overdraft is calculated by adding the largest overdraft incurred for each day during a reserve-maintenance period and dividing that sum by the number of business days in the period.

Bank may assign the institution a zero cap. In addition, the Reserve Bank may impose other account controls that it deems prudent, such as requiring increased clearing balances; rejecting Fedwire funds transfers, ACH credit originations, or NSS transactions in excess of the available account balance; or requiring the institution to fund certain transactions in advance. Reserve Banks also keep institutions' primary regulators apprised of any recurring overdraft problems.

## Real-Time Monitoring

The Account Balance Monitoring System (ABMS) is the system Reserve Banks use to monitor in real time the payment activity of institutions that potentially expose the Federal Reserve and other payment-system participants to excessive risk exposure. ABMS is both an information source and an account-monitoring and control tool. It allows institutions to obtain intraday balance information for purposes of managing their use of daylight credit and avoiding overnight overdrafts. All institutions that have an electronic connection to the Federal Reserve's Fedwire funds-transfer service, such as a FedLine® terminal or a computer interface connection, are able to review their intraday Federal Reserve account position in ABMS. While ABMS is not a substitute for an institution's own internal tracking and monitoring systems, it does provide real-time account information based on Fedwire funds and securities transfers and NSS transactions. Additionally, ABMS captures debits and credits resulting from other payment activity as those transactions are processed in the Reserve Bank's accounting system. ABMS also provides authorized Federal Reserve Bank personnel with a mechanism to monitor and control account activity for selected institutions.

ABMS has the capability to reject or intercept funds transfers from an institution's account. This capability is called *real-time monitoring*. The Federal Reserve Banks use real-time monitoring to prevent selected institutions from transferring funds from their accounts if there are insufficient funds to cover the payments. Institutions are generally notified before a Reserve Bank begins monitoring their account in real time.

If an institution's account is monitored in the

"reject" mode in ABMS, any outgoing Fedwire funds transfer, NSS transaction, or ACH credit origination that would cause an overdraft above a specified threshold, such as the institution's available funds, would be immediately rejected back to the sending institution. The institution could then initiate the transfer again when sufficient funds became available in its account. If an institution's account is monitored in the "intercept" mode, sometimes referred to as the "pend" mode, outgoing funds transfers, NSS transactions, or ACH credit originations that would cause an overdraft in excess of the threshold will not be processed but will be held. These intercepted transactions will either be released by the Reserve Bank once funds are available in the institution's account or rejected back to the institution. Reserve Banks will normally be in direct contact with an institution in the event any of its funds transfers are intercepted.

Institutions can view Federal Reserve accounting information on the web through FedLine. The Account Management Information (AMI) application provides real-time access to intraday account-balance and daylight-overdraft balance information, detailed transaction information, and a variety of reports and inquiry services. Institutions can obtain information on accessing ABMS and AMI from any Federal Reserve Bank or in the *Account Management Guide*.

## SPECIAL TYPES OF INSTITUTIONS

### U.S. Branches and Agencies of Foreign Banks

Under the PSR policy, U.S. branches and agencies of foreign banks are typically treated the same as domestic institutions. However, several unique considerations affect the way in which the policy is applied to U.S. branches and agencies of foreign banks. In general, net debit caps for foreign banking organizations (FBOs) are calculated in the same manner as they are for domestic banks, that is, by applying cap multiples for one of the six cap categories to a capital measure. For U.S. branches and agencies of foreign banks, net debit caps on daylight overdrafts in Federal Reserve accounts are calculated by applying the cap multiples for each

cap category to the FBO's U.S. capital equivalency measure. U.S. capital equivalency is equal to the following:

- 35 percent of capital for FBOs that are financial holding companies (FHCs)
- 25 percent of capital for FBOs that are not FHCs and have a strength-of-support assessment (SOSA) ranking of 1<sup>15</sup>
- 10 percent of capital for FBOs that are not FHCs and are ranked a SOSA 2
- 5 percent of "net due to related institutions" for FBOs that are not FHCs and are ranked a SOSA 3.

U.S. branches and agencies of foreign banks that (1) wish to establish a non-zero net debit cap, (2) are an FHC, or (3) are ranked a SOSA 1 or 2 are required to file the Annual Daylight Overdraft Capital Report for U.S. Branches and Agencies of Foreign Banks (FR 2225). Granting a net debit cap or any extension of intraday credit to an institution is at the discretion of the Reserve Bank. If a Reserve Bank grants a net debit cap or extends intraday credit to a financially healthy FBO ranked a SOSA 3, the Reserve Bank may require such credit to be fully collateralized, given the heightened supervisory concerns associated with these FBOs.

As it does with U.S. institutions, the ARB must have the ability to assess regularly the financial condition of a foreign bank in order to grant the institution a daylight-overdraft cap other than zero. The ARB will generally require information regarding tier 1 and total risk-based capital ratios for the consolidated foreign bank. Accordingly, U.S. branches and agencies of foreign banks seeking a positive daylight-overdraft cap (exempt, de minimis, or self-assessment cap categories) should provide the ARB with capital ratios at the time the cap is established and annually thereafter. Workpapers for capital ratios need to be maintained at a designated U.S. branch or agency and are subject to review by the institution's primary super-

visor. The Federal Reserve considers capital information provided to the ARB in connection with an institution's daylight-overdraft capacity to be confidential.

Effective March 26, 2009, a foreign bank that (1) is an FHC or (2) has a SOSA rating of 1 and has a self-assessed net debit cap may request from its Reserve Bank a streamlined procedure to obtain a maximum daylight overdraft capacity up to 100 percent times the net debit cap multiple. Also effective March 26, 2009, eligible foreign banks are granted a capital measure of 100 percent of capital for the purposes of calculating the deductible for daylight overdraft pricing.<sup>16</sup> The provision regarding the deductible will remain in effect until the implementation of the revised PSR policy, which eliminates the deductible for all institutions.

### *Allocation of Caps*

The Federal Reserve monitors the daylight overdrafts of U.S. branches and agencies of foreign banks on a consolidated basis; that is, each foreign-bank family, consisting of all of the U.S. branches and agencies of a particular foreign bank, has a single daylight-overdraft cap. Intraday account balances of all the U.S. branches and agencies in a foreign-bank family are added together for purposes of monitoring against its daylight-overdraft cap, in the same way that the account balances of institutions with accounts in more than one Federal Reserve District are added together.

For purposes of real-time monitoring, however, a foreign bank that has offices in more than one District may choose to allocate a portion of its net debit cap to branches or agencies in Districts other than that of the ARB. Unless a foreign-bank family instructs otherwise, the Federal Reserve will assign the dollar value of the family's single-day daylight-overdraft cap to the branch or agency located in the District of the ARB. The foreign-bank family may indicate to the ARB the dollar amount of cap to be allocated to offices in other Districts. Any dollar

15. The SOSA ranking is composed of four factors: the FBO's financial condition and prospects, the system of supervision in the FBO's home country, the record of the home country's government in support of the banking system or other sources of support for the FBO, and transfer-risk concerns. Transfer risk relates to the FBO's ability to access and transmit U.S. dollars, which is an essential factor in determining whether an FBO can support its U.S. operations. The SOSA ranking is based on a scale of 1 through 3, with 1 representing the lowest level of supervisory concern.

16. A deductible is a calculated amount that is subtracted from an institution's daylight overdraft charges. In order to be eligible for the interim deductible, FBOs must request and receive Reserve Bank approval for a streamlined max cap and have unencumbered collateral pledged at all times to its Reserve Bank equal to or greater than the amount of the deductible. Some max caps received under the general procedure may also be eligible.



amount of the cap that is not allocated to offices in other Districts will be assigned to the branch or agency in the District of the ARB. Annually, a foreign bank should update or confirm its cap allocation to its ARB.

## Nonbank Banks and Industrial Banks

Institutions subject to the Competitive Equality Banking Act of 1987 (CEBA), such as nonbank banks or certain industrial banks, may not incur daylight overdrafts on behalf of affiliates, except in three circumstances. First, the prohibition does not extend to overdrafts that are a result of inadvertent computer or accounting errors beyond the control of both the nonbank bank or industrial bank and its affiliate. Second, nonbank banks are permitted to incur overdrafts on behalf of affiliates that are primary U.S. government securities dealers, provided such overdrafts are fully collateralized. Third, overdrafts incurred in connection with an activity that is financial in nature are also permitted. A nonbank bank or industrial bank loses its exemption from the definition of bank under the Bank Holding Company Act if it permits or incurs prohibited overdrafts. In enforcing these restrictions, the Federal Reserve uses a separate formula for calculating intraday Federal Reserve account positions for these institutions.

## Institutions with Federal Reserve Accounts and No Access to the Federal Reserve Discount Window

Under the PSR policy, institutions that have Federal Reserve accounts but lack regular access to the discount window are not eligible for a positive daylight-overdraft cap. Institutions that do not have regular access to the discount window include Edge and agreement corporations, bankers' banks that are not subject to reserve requirements, limited-purpose trust companies, government-sponsored enterprises (GSEs), and certain international organizations. Institutions that have been assigned a zero cap by their Reserve Banks are also subject to special considerations under the PSR policy because of the risks they pose. All of these institutions are strongly discouraged from incurring any daylight overdrafts and are subject to a penalty fee on any average daily overdraft incurred. If any such

institutions were to incur an overdraft, however, the Reserve Bank would require it to pledge collateral sufficient to cover the peak amount of the overdraft for an appropriate period.

The penalty fee is intended to provide a strong incentive for these institutions to avoid incurring any daylight overdrafts in their Federal Reserve accounts. The penalty fee assessed is equal to the annual rate applicable to the daylight overdrafts of other institutions (36 basis points) plus 100 basis points multiplied by the fraction of a 24-hour day during which Fedwire is scheduled to operate (currently 21.5 divided by 24). The daily overdraft penalty fee is calculated by dividing the annual penalty rate by 360. The daylight-overdraft penalty rate applies to the institution's average daily daylight overdraft in its Federal Reserve account. Institutions that are subject to the daylight-overdraft penalty fee are subject to a minimum penalty fee of \$25 on any daylight overdrafts incurred in their Federal Reserve accounts.

## SPECIAL SITUATIONS

### Edge Act and Agreement Corporations

Edge Act and agreement corporations<sup>17</sup> do not have regular access to the discount window and should refrain from incurring daylight overdrafts in their Federal Reserve accounts. If any daylight overdrafts occur, the Edge Act or agreement corporation will be required to post collateral to cover them. Like foreign banks, Edge Act and agreement corporations that have branches in more than one Federal Reserve District are monitored on a consolidated basis. In addition to posting collateral, the Edge or agreement corporation would be subject to the daylight-overdraft penalty rate levied against the average daily daylight overdrafts incurred by the institution.

### Bankers' Banks

Bankers' banks<sup>18</sup> are exempt from reserve

17. These institutions are organized under section 25A of the Federal Reserve Act (12 USC 611-631) or have an agreement or undertaking with the Board of Governors under section 25 of the Federal Reserve Act (12 USC 601-604a).

18. For the purposes of the PSR policy, a bankers' bank is a financial institution that is not required to maintain reserves

requirements and do not have regular access to the discount window. Bankers' banks may voluntarily waive their exemption from reserve requirements, thus gaining access to the discount window. These bankers' banks would then be free to establish caps and would be subject to the PSR policy in the same manner as other institutions. Bankers' banks that have not waived their exemption from reserve requirements should refrain from incurring overdrafts and must post collateral to cover any daylight overdrafts that they incur.

### Limited-Purpose Trust Companies

The Federal Reserve Act (FRA) permits the Board to grant Federal Reserve membership to limited-purpose trust companies,<sup>19</sup> subject to conditions the Board may prescribe pursuant to the FRA. Limited-purpose trust companies that maintain Federal Reserve accounts should refrain from incurring overdrafts and must post collateral to cover any daylight overdrafts that they incur.

### Government-Sponsored Enterprises and Certain International Organizations

The Federal Reserve Banks act as fiscal agents for certain government-sponsored enterprises (GSEs) and international organizations.<sup>20</sup> These

institutions generally have Federal Reserve accounts and issue securities over the Fedwire Securities Service. The securities of these institutions are *not* obligations of, or fully guaranteed as to principal and interest by, the United States. Furthermore, these institutions are not subject to reserve requirements and do not have regular access to the discount window. GSEs and certain international organizations are to avoid incurring daylight overdrafts and must post collateral to cover any daylight overdrafts they do incur. In addition to posting collateral, these institutions are subject to the same daylight-overdraft penalty rate as other institutions that do not have regular access to the discount window.

### Problem Institutions

For institutions that are in weak financial condition, the Reserve Banks will impose a zero cap. The Reserve Bank will also monitor a problem institution's activity in real time and reject or delay certain transactions that would create an overdraft. Problem institutions should refrain from incurring daylight overdrafts and must post collateral to cover any daylight overdrafts they do incur.

## ELECTRONIC FUNDS TRANSFER ACTIVITIES

### EFT MANAGEMENT

Economic and financial considerations have led financial institutions and their customers to recognize the need to manage cash resources more efficiently. The PSR policy calls on private networks and institutions to reduce their own credit and operational risks. It also depends on the role of the Federal Reserve and other financial institution regulators in examining, monitoring, and counseling institutions. To ensure that banking institutions are following prudent banking practices in their funds-transfer activities, examinations should focus equally on the

under the Federal Reserve's Regulation D (12 CFR 204) because it is organized solely to do business with other financial institutions, is owned primarily by the financial institutions with which it does business, and does not do business with the general public and is not an institution as defined in the Federal Reserve's Regulation A (12 CFR 201.2(a)). For the purposes of the PSR policy, bankers' banks also include corporate credit unions.

19. For the purposes of the PSR policy, a limited-purpose trust company is a trust company that, because of limitations on its activities, does not meet the definition of "depository institution" in section 19(b)(1)(A) of the Federal Reserve Act (12 USC 461(b)(1)(A)).

20. The GSEs include Fannie Mae, the Federal Home Loan Mortgage Corporation (Freddie Mac), entities of the Federal Home Loan Bank System (FHLBS), the Farm Credit System, the Federal Agricultural Mortgage Corporation (Farmer Mac), the Student Loan Marketing Association (Sallie Mae), the Financing Corporation, and the Resolution Funding Corporation. The international organizations include the World Bank, the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank. The Student Loan Marketing Association Reorganization Act of 1996

requires Sallie Mae to be completely privatized by 2008; however, Sallie Mae completed privatization at the end of 2004. The Reserve Banks no longer act as fiscal agents for new issues of Sallie Mae securities, and Sallie Mae is not considered a GSE.

evaluation of credit, liquidity, and operational risks.

The bank should establish guidelines for types of allowable transfers. Procedures should be in effect to prevent transfers drawn against uncollected funds. Thus, banks should not transfer funds against simple ledger balances unless preauthorized credit lines have been established for that account.

Errors and omissions, as well as the fraudulent alteration of the amount of a transfer or of the account number to which funds are to be deposited, could result in losses to the bank. Losses may include total loss of the transferred funds, loss of availability of funds, interest charges, and administrative expenses associated with the recovery of the funds or correction of the problem.

Management is responsible for assessing the inherent risks in the EFT system, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring the effectiveness of safeguards. Regulatory agencies will ensure that each financial institution has evaluated its own risks realistically and has adequate accounting records and internal controls to keep exposures within reasonable, established limits.

The risks associated with any computerized EFT system can be reduced if management implements the controls that are available on the system. For example, the authority to enter, verify, and send transfers can be segregated, and the dollar amount of transactions can be limited. Effective risk management requires that management establish and maintain—

- reasonable credit limits (payments in excess of these limits that involve significant credit risk must be properly approved by appropriate lending authorities),
- adequate recordkeeping to determine the extent of any intraday overdrafts and potential overnight overdrafts before releasing payments, and
- proper monitoring of respondents' accounts when the institution sets the positions of others. Responsibility for this function should be assigned to an appropriate supervisory level of management that will ensure the use of adequate internal controls.

## Authentication or Verification Methods

The same due care that financial institutions use when executing EFT transactions must be used when accepting EFT requests from customers. Management must implement security procedures for ensuring that the transfer requests are authentic. As stated in Uniform Commercial Code (UCC) section 4A-201, "Authorized and Verified Payment Orders," security procedures may require the use of algorithms or other codes, identifying words, or numbers; encryption; callback procedures; or similar security devices. An explanation of authorized and verified payment orders is detailed in UCC section 4A-202.

### *Signature Verification*

One method to verify the authenticity of a customer's EFT request is to verify the customer's signature. Unfortunately, this procedure cannot be performed when the customer requests the transaction by telephone. Some financial institutions have implemented policies whereby the customer completes and signs a transfer request, and then faxes the request to the bank. However, this is not a safe EFT procedure because, although the bank can verify the signature on the faxed request, it cannot be certain that the transfer request is legitimate. Any document that is transmitted electronically can be altered (for example, by changing the amount or account number). The alteration can occur before the document is digitalized (that is, before being fed into the fax machine) or after. In most instances, these alterations cannot be detected by the receiving entity. If there is any question about a document's authenticity, the transaction should be reconfirmed through other sources.

### *Personal Identification Numbers*

One way for financial institutions to authenticate transfers initiated over the telephone is through the use of personal identification numbers (PINs) issued to each customer. When a customer requests a transfer, his or her identity is verified by comparing the supplied PIN with the customer's PIN-request form that is on file. At a

minimum, the following safeguards should be implemented for these types of transfers:

- All nonretail customers should be requested to sign an agreement whereby the bank is held harmless in the event of an unauthorized transfer if the bank follows routine authentication procedures. The customer is responsible for informing the bank about changes in who is authorized to execute EFTs. These procedures should minimize the risk to the bank if someone is able to execute a fraudulent transaction. (These procedures are described in detail in UCC section 4A-202.)
- All transactions over a specific dollar amount should be re-verified by a callback routine. The bank should require that the person being called for re-verification is someone other than the person who initially requested the transaction.
- Whenever new PINs are issued, they should be mailed in sealed, confidential envelopes (preferably computer-generated) by someone who does not have the ability to execute wire transfers.
- The number of bank employees who have access to PINs should be very limited.

### *Tape Recording*

The tape recording of EFT requests made over the telephone is another internal control practice. When possible, verifying and recording the incoming telephone number (that is, using a caller-ID system) is also a good practice. The laws addressing telephone recording vary by state. Some states require that the caller be informed that the conversation is being recorded; others do not have this requirement. Regardless of the state's law, the bank should inform callers that, for their protection, conversations are being recorded. Moreover, banks should have in place a policy for archiving the taped telephone records and should retain them for a specified period of time, at least until the statements from the Federal Reserve or correspondent banks have been received and reconciled.

### *Statements of Activity*

Some larger banks have implemented a procedure whereby customers are electroni-

cally sent a summary statement at the end of each day. The statement lists the transfers executed and received on their behalf. The statement can be sent through a fax machine, a personal computer, or a remote printer. This procedure quickly identifies any transfers the customer did not authorize.

### *Test Keys*

EFT requests can be authenticated using *test keys*. A test key is a calculated number that is derived from a series of codes that are contained in a test-key book. The codes in a test-key book represent such variables as the current date, hour of the day, receiving institution, receiving account number, and amount of the transfer. The value derived from these variables equals the test key. The financial institution or corporate customer initiating the transfer will give its EFT information, along with the test-key value. The receiving bank will recalculate the test key and, if the two test keys equal the same amount, the EFT request is considered authenticated. Test-key code books should be properly secured to prevent unauthorized access or fraudulent use. The use of test keys has declined in recent years as more and more institutions implement PC-based EFT systems.

### **Blanket Bond**

Although computer-related employee misappropriations are normally covered, financial institution blanket bond policies generally exclude certain types of EFT activities from standard coverage. Separate coverage for EFT systems is available and should be suggested to management, particularly if a significant risk exposure exists. A bank's fidelity bond insurance could be declared null and void by the carrier if a fraudulent transfer were to occur and the loss was directly attributable to weak internal controls. (See section 4040.1, "Management of Insurable Risks.")

### **SUPERVISORY RISK EVALUATION**

Bank management is responsible for assessing the inherent risks in the EFT system (or

systems) it uses. Management should establish policies and controls to protect the institution against unreasonable exposures, as well as monitor the effectiveness of the established safeguards.

## Examiner Responsibilities

Examiners are responsible for ensuring that financial institutions have assessed and evaluated their risks realistically and have adopted internal controls that are adequate to keep those risks within acceptable limits. The types of risks involved in EFT systems, as well as payment systems generally, are discussed below.

### *Credit Risk*

Credit risk is the risk that a counterparty will not settle an obligation for full value when due, nor at any time subsequently. Any time an institution extends credit to a customer or permits a customer to use provisional funds to make a payment, the institution is exposed to the risk that the customer will not be able to meet its payment obligation. If the customer is unable or unwilling to repay the credit extension, the institution could incur a financial loss. Similarly, an institution that receives a payment in provisional funds has a credit exposure to the sender until such time as the payment is settled with finality, that is, until the payment becomes unconditional and irrevocable. If an institution permits a customer to withdraw or make a payment with provisional funds received, then the institution incurs credit exposure to both the sender of the provisional funds and the customer. Those credit exposures are not extinguished until the provisional funds received are settled with finality. With respect to payment systems risk, overall credit risk consists of (1) direct-credit risk to the Federal Reserve, that is, a borrowing institution may be unable to cover its intraday overdraft arising from a transfer of funds or receipt of book-entry securities, thus causing a Federal Reserve Bank to incur a loss; (2) private direct-credit risk, or the possibility of loss to institutions extending credit; and (3) systemic risk, which is the possibility of loss to multiple creditors when borrowing institutions fail to cover their obligations to creditor institutions. Variants of credit

risk include sender risk, receiver risk, and return-item risk.

*Systemic risk.* Stated more clearly, systemic risk occurs when one participant in a payment system, or in the financial markets generally, fails to repay its required obligation when due, and this failure prevents other private or market participants or financial institutions from meeting their settlement obligations when due. Systemic risk may result from extraneous events, actions, or reasons that are independent of the institution, or from developments in the payment system. Changes in the capital markets, domestic political or government announcements or actions, unplanned events, or sovereign actions of other countries are examples of events that may cause systemic risk.

*Sender risk.* Sender risk is the risk that results if a depository institution uses an extension of credit to make an irrevocable payment on behalf of a customer. This credit can be a loan or an extension of payment against uncollected or provisional funds or against insufficient balances.

*Receiver risk.* Receiver risk arises when an institution accepts funds from a sender who may be a customer, another institution, or the payment system. As the receiver of funds, the institution relies on the sender's ability to settle its obligations. The risk exists while payments are revocable within the system and remains until final settlement.

*Return-item risk.* The major risk in originating ACH debit transactions and collecting checks for customers is return-item risk. Return-item risk extends from the day funds are made available to customers until the individual items can no longer legally be returned. The receiver of ACH debit transactions, or the payer of checks, has the right to return transactions for various reasons, including insufficient funds in its customer's account. To minimize its exposure, an institution should perform credit assessments of all customers that originate large dollar volumes of ACH debit transactions, and for all customers for which the institution collects large volumes of checks. Such assessments ensure that if ACH or check items are returned after the customer has been granted use of the funds, the customer will be able to return the funds to the institution.

### *Liquidity Risk*

Liquidity risk is the risk that a counterparty will not settle an obligation for full value when due, even though the counterparty may later settle the obligation. Liquidity risk may result from unexpected market or operational disruptions or from catastrophic or unplanned events. It may also result from sovereign actions; therefore, sovereign risk can give rise to liquidity risk.

### *Sovereign Risk*

Sovereign risk refers to the financial capacity of governments to generate foreign-currency revenues to repay their obligations. This capacity is generally limited because government assets are predominantly the discounted value of future taxes denominated in the local currency. Governments have direct access to foreign-currency revenues only when the economy is dominated by a public sector that derives most of its revenues from exports (for example, oil or gold). Sovereign risk is not limited to the country's federal government debt. It also includes debt contracted by all public and publicly guaranteed entities (such as provincial, state, or local governments and all other debt with a government's guarantee).

Actions taken by nondomestic governments can affect the payments of certain participants in a payment system, and these actions can be detrimental to other participants in the system. Sovereign risk can include the imposition of exchange-control regulations on a bank participating in international foreign-exchange activities. While the bank itself may be both willing and able to settle its position, government intervention may prevent it from doing so. The risk can be controlled by regularly monitoring the payment-system laws of other countries and by taking specific alternative actions to lessen the risk. Alertness to a bank's sovereign-risk exposure to its counterparties located in other nations, and to possible alternative actions, can considerably lessen this risk.

### *Legal Risk*

Any transaction occurring in a payment system is subject to the interpretation of courts in different countries and legal systems. This issue is normally addressed by adopting "govern-

law" provisions in the rules of the systems themselves. These provisions provide for all disputes between members to be settled under the laws of a specific jurisdiction. However, if a local court refuses to recognize the jurisdiction of a foreign court, the rules may be of limited use. This risk is difficult to address because there is no binding system of international commercial law for electronic payments. Banks should seek a legal opinion regarding the enforceability of transactions settled through a particular system.

### *Operational Risk*

Operational risk may arise from—

- a system failure caused by a breakdown in the hardware or software supporting the system, possibly resulting from design defects, insufficient system capacity to handle transaction volumes, or a mechanical breakdown, including telecommunications;
- a system disruption if the system is unavailable to process transactions, possibly due to system failure, destruction of the facility (from natural disasters, fires, or terrorism), or operational shutdown (from employee actions, a business failure, or government action); or
- the system being compromised as a result of fraud, malicious damage to data, or error.

Whatever the source, the loss of availability of a payment system can adversely affect major participants, their correspondents, markets, and interdependent payment mechanisms.

Banks should control operational risk through a sound system of internal controls, including physical security, data security, systems testing, segregation of duties, backup systems, and contingency planning. In addition, a disruption to a bank's own internal payment processing systems or its access to external payment systems can adversely affect both the bank's own payments activities, as well as those of other participants in a payment system. As such, a comprehensive audit program is essential to assess the risks, adequacy of controls, and compliance with bank policies.

## Risk-Control Issues

Bank management should consider and develop risk-management policies and procedures to address the variety of credit, liquidity, operational, and other risks that can arise in the normal course of conducting its payment business—regardless of the clearing and settlement method of the particular payment systems in which the bank participates. EFT systems differ widely in form, function, scale, and scope of activities. Consequently, the specific risk-management measures an institution employs for a particular EFT system will differ depending on the inherent risks in the system. As a general matter, an institution should adopt risk-management controls commensurate with the nature and magnitude of risks involved in a particular EFT system.

In addition to assessing the adequacy of an institution's risk-management procedures for measuring, monitoring, and controlling its risks from participating in a payment system (or systems) and from providing payment services to its customers, examiners should consider the following internal control guidelines when they review policies and procedures covering EFT activities:

- Job descriptions for personnel responsible for a bank's EFT activities should be well defined, providing for the logical flow of work and adequate segregation of duties.
- No single person in an EFT operation should be responsible for all phases of the transaction

(that is, for data input, verification, and transmission or posting).

- All funds transfers should be reconciled at the end of each business day. The daily balancing process should include a reconciliation of both the number and dollar amount of messages transmitted.
- All adjustments required in the processing of a transfer request should be approved by a bank's supervisory personnel, with the reasons for the adjustment documented. Transfer requests "as of" a past or future date should require the supervisor's approval with well-defined reasons for those requests.
- Only authorized persons should have access to EFT equipment.

Considerable documentation is necessary to maintain adequate accounting records and auditing control. Many banks maintain transfer-request logs, assign sequence numbers to incoming and outgoing messages, and keep an unbroken electronic copy of all EFT messages. At the end of each business day, employees who are independent of the transfer function should compare request forms with the actual transfers to ensure that all EFT documents are accounted for. When reviewing the adequacy of internal controls, examiners should review the funds-transfer operations to determine that recordkeeping systems are accurate and reliable, all transactions are handled promptly and efficiently, duties are separated appropriately, audit coverage is adequate, and management recognizes the risks associated with these activities.

# Payment System Risk and Electronic Funds Transfer Activities Examination Objectives

Effective date May 2002

## Section 4125.2

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1. To determine if the bank's electronic funds transfer (EFT) objectives, policies, practices, procedures, and internal controls are adequate to control its exposure to acceptable limits of payment systems risk.
2. To determine if bank officers and other wire-transfer personnel are operating in conformance with established guidelines.
3. To determine the scope and adequacy of the audit function for the risks associated with payment and wire-transfer systems.
4. To ascertain whether senior management is informed of the current status, nature, and magnitude of risks associated with the bank's EFT operations, as well as any changes to these risks.
5. To assess the bank's ability to monitor its payment-systems position, as well as to limit its credit and other risk exposures in the system and from its customers or correspondents.
6. To determine that the board of directors has reviewed and approved the institution's use of Federal Reserve intraday credit, self-assessment (if applicable), and net debit cap, and to determine if the institution is complying with the Federal Reserve Policy Statement on Payments System Risk.
7. If the bank has a self-assessed net debit cap, to review the bank's self-assessment file and determine if the underlying analyses and methodologies are reasonable, adequate, and consistent with the institution's supervisory overview, risk assessments, and risk matrix.
8. To evaluate the quality of the bank's operational controls and determine the extent of compliance with applicable laws and regulations.
9. To initiate corrective action when objectives, policies, procedures, or internal controls are deficient or when violations of law or regulations exist.



# Payment System Risk and Electronic Funds Transfer Activities Examination Procedures

Effective date November 2004

Section 4125.3

1. Review and determine the bank's compliance with the electronic funds transfer (EFT) risk-assessment standards of the examination module, recognizing the associated risks for each. Answer the pertinent questions that refer to EFT in the internal control questionnaire.
2. Review and evaluate the work of internal or external auditors and of the compliance officer as it relates to the risks associated with payment systems and EFT activities. Determine if payment system risk is reviewed and whether the independence, scope, coverage, and frequency of internal or external reviews are adequate.
3. Based on an evaluation of internal controls and the work performed by internal or external auditors, determine the scope of the examination.
4. Test for compliance with policies, practices, procedures, and internal controls. Determine whether the management information systems and reports for the institution's payment systems and funds-transfer activities provide timely and accurate data that are sufficient for personnel to make informed and accurate decisions. From the examiner assigned to review "Internal Control," obtain a listing of any deficiencies noted in the latest review conducted by internal or external auditors. Determine if bank management has taken the appropriate corrective actions for the deficiencies.
5. Obtain or construct an organizational chart and flow chart for the EFT area, and determine the job responsibilities and flow of work through that department.
6. Review the bank's standard form of agreement or other written agreements with its customers, correspondent banks, and vendors. Determine whether those agreements are current and clearly define the liabilities and responsibilities, including responsibilities during emergencies, of all parties. Agreements with the Federal Reserve Bank should refer specifically to the operating circular (or circulars) on the electronic funds transfers pursuant to subpart B of Regulation J (12 CFR 210.25 et seq.).
7. Review the bank's board of directors and senior management policies and procedures for payment-systems and EFT activities, including third-party transactions. Perform tests to determine the existence, reasonableness, and adequacy of these policies and procedures. Determine whether the policies and procedures have been disseminated to the employees who are actively responsible for and involved in performing payment-systems and EFT activities. Ascertain whether there is an active employee-training program that ensures employees have the knowledge necessary to comply with the bank's policies and procedures for payment-systems and EFT activities.
8. For transactions involving the Federal Reserve Bank, other private funds-transfer systems, and other due from bank accounts, confer with the examiner who is assigned "Due from Banks," and determine the propriety of any outstanding funds-transfer items.
9. Coordinate the review of the credit exposures arising from payment-systems and EFT activities with the examiners' review of loan programs or loan portfolios. Determine whether credit personnel make and adequately document, independent of account and operations officers, periodic credit reviews of funds-transfer customers.
10. Determine where suspense items or adjustment accounts are posted and accounted for, as well as who is responsible for reviewing, resolving, and clearing out suspense items.
  - a. Scan accounts for unusual or old items or abnormal fluctuations.
  - b. Reconcile accounts to departmental control totals and to the general ledger.
  - c. Review management reports on suspense items and unusual activity.
11. Review the income and expense accounts related to EFT operations. Determine the frequency of entries caused by late or inaccurate execution of transfer requests.
12. Observe the space and personnel allocated to the EFT area, and note the location of communications terminals. Determine whether existing conditions are adequate to provide appropriate physical security.
13. Discuss the following items with the appropriate officer (or officers), and prepare summaries in the appropriate section of the

examination report:

- a. internal control exceptions, as well as deficiencies in or noncompliance with written policies, practices, and procedures
  - b. uncorrected audit deficiencies
  - c. violations of laws and regulations
  - d. terminology, operating arrangements, accounting procedures, and time limitations of EFT operations
  - e. the operating efficiency and physical security of the bank's EFT operation
  - f. the adequacy of controls over settlement- and credit-risk exposure
  - g. recommended corrective action when policies, practices, or procedures are deficient
14. Update the examination workpapers to include the bank examination activities and procedures performed and any information gathered to support the completed work, including any information that will facilitate future examinations.

## RISK MANAGEMENT OF INTRADAY CREDIT EXPOSURES

1. If the bank is a CHIPS or other clearing-agency participant, determine the bank's basis for accepting customers for CHIPS-payments activity. If the examined institution is a funding participant on CHIPS, determine the criteria for accepting a non-funding participant as a respondent. Determine that the criteria are reviewed periodically.
2. Determine if appropriate intraday credit limits are imposed and monitored for those customers and counterparties with which the bank has intraday credit exposures.
3. Determine if the bank monitors and controls any intraday credit exposures to affiliates.<sup>1</sup>

1. An insured depository institution must establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from its intraday extensions of credit to affiliates in a safe and sound manner. The policies and procedures must at a minimum provide for the monitoring and control of the credit exposure arising from the institution's intraday extensions of credit to each affiliate and

4. Determine whether the institution periodically reviews its ability to fund its closing-position requirement on private multilateral settlement systems, such as CHIPS.

## FEDERAL RESERVE INTRADAY CREDIT

1. Determine that the board of directors has reviewed and approved the institution's use of Federal Reserve intraday credit.
2. If the institution incurs daylight overdrafts in its Federal Reserve account, determine that the institution has selected an appropriate net debit cap.
3. If the institution has selected a de minimis or a self-assessed net debit cap, determine that the board-of-directors resolution follows the prescribed format and contains all of the required elements.
4. If the institution has selected a self-assessed net debit cap, review the contents of the self-assessment file to determine that the institution has applied the guidelines appropriately and diligently, that the underlying analysis and method were reasonable, and that the resulting self-assessment is generally consistent with the examination findings. Inform the appropriate Reserve Bank of any concerns about the institution's net-debit-cap level, self-assessment, or use of Federal Reserve intraday credit.
5. Review the institution's cap resolution file and ascertain that it includes (1) a copy of the board-of-directors resolution, (2) worksheets and supporting analysis used in its self-assessment of its own cap category, (3) copies of senior-management reports to the board of directors of the institution or its parent (as appropriate) regarding that self-assessment, and (4) copies of the minutes of the discussion at the appropriate board-of-directors meeting concerning the institution's adoption of a cap category.

all affiliates in the aggregate, and must ensure that the institution's intraday extensions of credit to affiliates comply with section 23B of the Federal Reserve Act. (See 12 CFR 250.248.)

# Payment System Risk and Electronic Funds Transfer Activities Internal Control Questionnaire

Effective date May 2002

Section 4125.4

For the preliminary review and assessment, review the bank's internal controls, policies, practices, and procedures for payment systems risk and electronic funds transfer (EFT) activities. The following procedures should be used:

1. Review previous examination reports, earlier workpapers, and correspondence exchanged with the institution to get an overview of previously identified EFT concerns.
2. Review the most recent audits and internal reviews to identify the scope and noted deficiencies.
3. Review management's actions to correct examination and audit deficiencies.
4. Discuss with management recent or planned changes in EFT activities.
5. Review management reports to determine the nature and volume of current activity.
6. Review the minutes of management committees that oversee EFT activity to determine their content and follow-up on material matters.

The bank's payment and EFT systems should be further reviewed and documented completely and concisely. Where appropriate, the preliminary review and assessment should include narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

During the examination, the review of operations and internal controls of all institutions involved in funds-transfer or EFT activities should use the following procedures. Items below that are marked with an asterisk (\*) require substantiation by observation or testing.

## ORGANIZATION

1. Is there a current organization plan detailing the structure of the funds-transfer function?
2. Is senior management responsible for administering the operations of the funds-transfer function?
3. Does management maintain a current list of bank personnel who are authorized to initiate EFT requests?
4. Are there regular management reviews of

staff compliance with the credit and personnel procedures, operating instructions, and internal controls?

5. Are activity and quality-control reports received and reviewed by management?
6. Are major new system designs and newly available hardware for the payment and EFT systems brought to the attention of and reviewed by management?

## SUPERVISION BY DIRECTORS AND SENIOR MANAGEMENT

1. Are the directors and senior management kept informed about the nature and volume of transactions and the magnitude of the risks involved in the funds-transfer activity?
2. Has the board of directors or senior management reviewed and approved any limits on the risks in the funds-transfer activities? If so, when were the limits last reviewed?
3. Is senior management or the board of directors advised of any customers with—
  - a. large intraday and overnight overdrafts? If so, are other extensions of credit to the same customers combined to show the total credit exposures?
  - b. large drawings against uncollected funds?
4. Are management's responses to audit exceptions and recommendations adequate and timely?
5. Is there adequate insurance coverage for EFT risks? Does senior management conduct adequate reviews of insurance coverage and insurance riders for EFT operations and the overall EFT environment?

## CREDIT MANAGEMENT, EVALUATION, AND APPROVAL

1. Under the bank's established board-of-directors policies and procedures, is senior management or the credit committee (or credit officers) required to review at pre-determined frequencies—

- a. the volume of transactions, the credit-worthiness of customers, and the risks involved in the funds-transfer activity?
  - b. credit and other exposures as they relate to safe and sound banking practices?
  - c. staff capabilities and the adequacy of equipment relative to current and expected volume?
2. Are procedures in place to prohibit transfers of funds against accounts that do not have collected balances or preauthorized credit availability?
  3. Have counterparty and customer credit limits been established for all payment system risk exposures, including those relating to Fedwire, CHIPS, ACH, foreign exchange, and other types of payments? Do credit limits take into account intraday and overnight overdrafts?
    - a. Are groups of affiliated customers included in such limits?
    - b. Are limits set according to a clear and consistent methodology for credit-risk assessment?
    - c. How often are the limits reviewed and updated?
    - d. Does senior management monitor and review the customer limits? How frequently?
  4. Are other types of credit facilities considered when establishing intraday-overdraft limits for the same customer?
  5. Is an intraday-posting record kept for each customer, showing opening collected and uncollected balances, transfers in, transfers out, and the collected balances at the time payments are released?
  6. If payments exceed the established limits, are steps taken in a timely manner to obtain covering funds?
  7. Are there fully documented, periodic credit reviews of funds-transfer customers?
  8. Are credit reviews conducted by competent credit personnel who are independent of account and operations officers?
  9. Does the institution make payments in anticipation of receiving covering funds? If so, are such payments approved by officers who have the appropriate credit authority?
  10. Are intraday exposures limited to amounts that are expected to be received the same day?
  11. Do the limits on intraday and overnight overdrafts appear to be reasonable in view of the institution's capital position and the creditworthiness of the respective customers?
  12. Does a staff supervisor approve payments in excess of established limits, following verification that the covering funds are in transit to the bank?
  13. Before releasing payments, are payments against uncollected funds and intraday overdrafts in excess of established limits referred to a person with appropriate credit authority for approval, and is the reason for the overdraft determined?

## PERSONNEL

1. Has the bank taken steps to ensure that screening procedures are applied to personnel that are hired for sensitive positions in the EFT departments?
2. Does the bank prohibit new or temporary employees from working in sensitive areas of the payment-systems and EFT operation?
3. Are statements of indebtedness required from employees who work in sensitive positions of the payment-systems and EFT function?
4. Does supervisory staff give special attention to employees newly assigned to work in the EFT functions?
5. Are employees subject to unannounced rotation of responsibilities, regardless of the size of the institution?
6. Are relatives of employees in the payment-systems and EFT function precluded from working in the same institution's book-keeping or data processing departments?
7. Does the bank's policy require that employees take a minimum number of consecutive days as part of their annual vacation? Is this policy being enforced?
8. If employees have given notice of resignation or received termination notices, does management reassign them away from sensitive areas of the payment-systems and EFT function?
9. Are personnel informed of the current trends in transfer activities, including necessary internal controls, as part of a regular training program?

## SIGNATURE CARDS

1. Does the bank maintain a current list or card file of authorized signers for customers who use the bank's funds-transfer services?
2. Are customer signature cards maintained under dual control or otherwise protected?
3. Do customer signature cards limit the number of authorized persons and the amount of funds that an individual is authorized to transfer?
4. Do bank personnel compare the signature on an original mail request with the authorized signature on file?

## TEST KEYS

1. Do telephone requests and EFT transactions use test codes, and are the codes verified by a person other than the person receiving the request?
2. Are test codes restricted to authorized personnel?
- \*3. Are the files containing test-key formulas maintained under dual control or otherwise protected?
4. Are only authorized personnel permitted in the test-key area or allowed access to computers, teletapes, or terminals?
5. Does the bank maintain an up-to-date test-key file?
6. Does management maintain a list of those authorized persons who have access to test-key files?
7. Are all messages and transfer requests that require testing authenticated by the use of a test key?
- \*8. Are test codes verified by someone other than the person receiving the initial transfer request?
9. Are callback or other authentication procedures performed on all transfers that do not have a test key or signature card on file?
10. Do mail transfer requests include a test word as an authentication procedure?
11. Does the bank's test-key formula incorporate a sequence number resulting from an agreement between the bank and the customer?

12. Does the bank have procedures in operation for the issuance and cancellation of test keys?
- \*13. Is the responsibility for issuing and canceling test keys assigned to someone who is not responsible for testing the authenticity of transfer requests?
14. Are test codes maintained in a secure environment when they are not in use?
15. Is the testing area physically separated from other operations?

## TELEPHONE TRANSFER REQUESTS

1. Has the bank established guidelines for what information should be obtained from a person making a funds-transfer request by telephone?
2. Does the above information include a test-word authentication code?
3. Does the bank use a callback procedure that includes a test-code authentication to verify telephone transfer requests?
4. Does the bank limit callbacks to transactions over a certain dollar amount?
5. Does the bank maintain a current list of persons who are authorized to initiate telephone funds transfers and messages?
- \*6. Does the bank have procedures in place to prohibit persons who receive telephone transfer requests from transmitting those requests?
7. Does the bank use devices that record all incoming and outgoing transfer requests?
8. Are prenumbered or sequentially numbered (at a central location after initiation) transfer-request forms used?
9. Is the log or record of transfer requests reviewed daily by supervisory personnel?
10. Do the records of transfer requests contain—
  - a. a sequence number?
  - b. an amount transferred?
  - c. the person, firm, or bank making the request (also the specific transferor)?
  - d. the date?
  - e. the test-code authentication?
  - f. paying instructions?
  - g. authorizing signatures for certain types and dollar-amount transfers?

## EFT REQUESTS

- \*1. Do different employees perform the functions of receipt, testing, and transmission of funds-transfer requests?
2. Do incoming and outgoing messages record the time, or are they sequentially numbered for control?
3. Do incoming and outgoing messages include a test word as a means of message authentication?
4. Is an unbroken copy of all messages kept throughout the business day?
5. Is the above copy reviewed and controlled by someone not connected with operations in the EFT area?

## AGREEMENTS

1. With respect to EFT and payment-systems transfer operations between the bank and its hardware and software vendors, maintenance companies, customers, correspondent banks, the Federal Reserve, and other providers, are the agreements in effect and current? (The agreements with the appropriate Federal Reserve Bank should refer to the operating circulars regarding the transfer of funds pursuant to subpart B of Regulation J.)
2. Do the written agreements state the responsibilities of each party involved in the agreement?
3. Do the agreements state the vendors' liabilities for their employees' actions?

## OPERATING AND PROCESSING PROCEDURES

1. Do written procedures exist for the EFT functions, and are they updated for employees in the incoming, preparation, data entry, balance-verification, transmission, accounting, reconciling, and security areas? Do these procedures include—
  - a. control over test words, signature lists, and opening and closing messages?
  - b. computer-terminal security and password controls?
  - c. access to the funds-transfer and EFT areas and user files?
  - d. origination, modification, deletion, or rejection of order transactions or messages?
- e. verification of the sequence numbers of orders?
- f. accounting for all transfer requests and message traffic at the end of the day?
- g. bank supervisory review of all adjustments, reversals, and the reasons therefor, as well as open items?
- h. planning for contingencies?
2. Are all incoming and outgoing payment orders and message requests in the EFT and funds-transfer area—
  - a. time-recorded or sequentially numbered for control?
  - b. logged?
  - c. reviewed for test verification?
  - d. reviewed for signature authenticity?
  - e. reviewed to verify that the person who initiated the funds-transfer request was authorized to do so?
  - f. authorized or reviewed by bank supervisory personnel?
3. Does the EFT department of the bank prepare a daily reconciliation of funds-transfer activity by dollar amount and number of messages?
4. Are all rejects or exceptions reviewed by someone who is not involved in the receipt, preparation, or transmittal of funds?
5. If the institution accepts transfer requests after the close of business or accepts transfer requests with a future value date, are they properly controlled and processed?
6. Are Federal Reserve Bank statements reviewed and reconciled daily with the bank's internal funds-transfer log to determine if there are "open" funds-transfer items and the reasons for the outstanding items?
7. Does an officer review corrections, overrides, open items, reversals, and other adjustments?
8. Does a person other than the receipt clerk review message requests and payment orders for—
  - a. the propriety of the transactions?
  - b. future dates, especially those for multiple transactions?
9. When reasonably feasible, does a supervisor check all transactions before the release of funds to a customer or before initiating a payment message over the EFT system?

10. At the end of a day, are all message requests and payment orders accounted for in an end-of-the-day proof to ensure that all requests have been processed?
  11. Are internally rejected customer transfer requests and message requests controlled, and are they sequentially numbered for accountability?
  12. Does an officer review and approve as-of adjustments, open items, reversals, and other adjustments?
  13. Are key fields re-verified before transmission, and are messages released by someone other than the individual who originally entered the message?
  14. Does the work flow in a one-way direction to provide adequate internal controls?
  15. Are audit trails maintained from receipt through posting to a customer's account?
  16. Are EFT activities adequately documented, and is there an adequate and active records-retention program?
- ers that indicate amounts to be paid and received and the source of covering funds?
  8. If the above detail of receipts is not received, do the institution's customers inform it of the total amount to be received for the day?
  9. Is the information in items 7 and 8 maintained and followed for exceptions?
  10. Is an intraday-posting record kept for each customer, showing opening collected and uncollected balances, transfers in, transfers out, and the collected balance at the time payments are released?
  11. Are significant CHIPS or Fedwire customer payments and receipts communicated to a monitoring unit promptly during the day to provide adequate information on each customer's overall exposure?
  12. Does the accounting system for demand deposits give an accurate collected-funds position?
  13. Have limits been established within which a designated person may authorize release of payments after reviewing the customer's activity? Does the institution maintain a record of approvals of these releases?
  14. When an overnight overdraft occurs, is a determination made as to whether a fail caused the overdraft? If so, is this determination properly documented? Are follow-up actions to obtain the covering funds in a timely manner adequate?
  15. Does the institution have a record of payments it failed to make?
  16. Is the above record reviewed to evaluate the efficiency of the department?
  17. Is corrective action initiated when appropriate?
  18. Are investigations and follow-ups for failed payments conducted by personnel who are independent of the operating unit?
  19. Are customer advices issued in a timely manner? Do credit advices sent to customers clearly indicate that credits to their accounts that are received through CHIPS are conditional upon final settlement?
  20. For the settling institutions on CHIPS, are the net debit positions of the nonsettling participants relayed to appropriate personnel as soon as the positions become known?
  21. Are designated supervisory staff responsible for verifying that respondents' net debit positions are covered the same day?
  22. Are the follow-up procedures adequate to facilitate the receipt of funds?

## ACCOUNTING, RECORDKEEPING, AND CONTROLS

1. Are Federal Reserve Bank, correspondent bank, and clearinghouse statements used for funds transfers reconciled daily in another area of the bank (for example, accounting or correspondent banking or by a person who is separate from any money-transfer operations) to ensure that they agree with the funds-transfer records?
2. Are all prenumbered forms, including cancellations, accounted for in the daily reconciliation, and do they include the account number and account title?
3. Is the daily reconciliation of funds-transfer and message-request activity reviewed by supervisory personnel?
- \*4. Is the balancing of daily activity conducted separately from the receiving, processing, and sending functions?
5. Does the EFT department verify that work sent to other bank departments agrees with its totals?
6. Are general-ledger entries, adjustments, automated transactions, or other supporting documents initialed by authorized persons?
7. Does the institution receive cables or other written communications from its custom-

23. Are open-statement items, suspense accounts, receivables, or payables and interoffice accounts related to EFT activity controlled outside of the funds-transfer operations?
24. Do the following controls exist?
  - a. Management prepares periodic reports on open-statement items, suspense items, and interoffice accounts.
  - b. Reports include agings of open items, the status of significant items, and the resolution of prior significant items.
25. Do general-ledger tickets or other supporting documents include the initials of the originator and designated supervisory personnel?
26. Is senior management required to decide whether to refuse to cover a net debit settlement position of a respondent?
27. Has the institution devised and maintained an adequate system of internal accounting controls, as required by the Foreign Corrupt Practices Act?

## AUDIT

1. Does management or the audit department undertake a periodic review to ensure that work is being performed in accordance with policy and guidelines established by the board of directors and senior management?
2. Is the audit department promptly informed when a change is made in systems or the method of operation?
3. Does the audit or independent-review program provide sufficient coverage relative to the magnitude (volume) and nature of EFT activities? Are independent reviews conducted, and do they address all areas of EFT business, including—
  - a. payment-order origination (funds-transfer requests);
  - b. message testing;
  - c. credit evaluation;
  - d. customer agreements;
  - e. payment processing and accounting;
  - f. personnel policies;
  - g. physical and data security;
  - h. contingency plans;
  - i. credit evaluation and approval;
  - j. incoming funds transfers;
  - k. bank secrecy and foreign assets control,

if applicable; and

- l. Federal Reserve payment system risk program and policy issues.

## PHYSICAL SECURITY

1. Is access to the EFT area restricted to authorized personnel who have proper bank identification? In limited circumstances when visitors are necessary (such as for repairs of equipment), are they restricted, properly identified, required to sign in, and accompanied by authorized personnel at all times?
2. Is written authorization given to those employees who remain in the EFT area after normal working hours? Who gives such authority? Are security guards informed?
3. Are bank terminal operators or others in EFT operations denied access to computer areas or programs?
4. Do procedures prohibit computer personnel from gaining access to bank terminals or test-key information?
5. Does EFT equipment have physical or software locks to prohibit access by unauthorized personnel at all times?
6. Are terminals and other hardware in the EFT area shut down after normal working hours? Are they regulated by automatic time-out controls or time-of-day controls?
7. Are passwords suppressed when they are entered in terminals?
8. Are operator passwords frequently changed? If so, how often?
9. Is supervisory approval required to access terminals at other than authorized times?
10. Are passwords restricted to different levels of access, such as data files and transactions that can be initiated?
11. Are employees prohibited from taking access keys for sensitive equipment or software test keys out of the EFT area?

## CONTINGENCY PLANS

1. Has management properly planned for contingencies, and has it developed a reasonable contingency plan and safeguards that are commensurate with the volume of EFT activity?



2. Does the bank maintain backup communications systems, and is supervisory approval required for their use?
3. Are procedures in place for sending and receiving transfers if the bank is forced to operate at a different site?
4. Are backup systems and equipment periodically tested by bank personnel?
5. Are there adequate procedures to ensure that data is recovered by the opening of the next business day's processing?
6. Have written contingency plans been developed and regularly tested in case of partial or complete failure of the bank's systems or of communication lines between the bank and the New York Clearing House, the Federal Reserve Bank, data centers, critical customers, or servicer companies?
7. Are contingency plans reviewed regularly and tested at least annually?
8. Has management distributed contingency plans to all personnel and stored appropriate copies off-site or in a central database?
9. If the bank processes a large volume of payments, does it maintain a backup facility that provides real-time recovery in case of a disaster or other disruption of the primary data center?
10. Are procedures in place for backup, off-site storage of critical information and for inventory control on hardware and software?
11. Do procedures exist to prevent the inadvertent release of test data into the production environment?
12. Are primary and backup telecommunication lines performance-tested frequently by authorized supervisory personnel?

For guidance and listed procedures on Fedline, EFT, and information technology standards, see chapters 18 and 19 of the *FFIEC Information Systems Examination Handbook*.

## CONCLUSION

1. Is the foregoing information an adequate basis for evaluating internal control; that is, there are no significant internal-auditing procedures, accounting controls, administrative controls, or other deficiencies or circumstances in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).
3. If intraday credit is granted to any affiliates, has the bank established policies and procedures to monitor and control such exposures and ensure compliance with section 23B of the Federal Reserve Act, as required by Regulation H? (See 12 CFR 250.248.)
4. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (good, medium, or bad).
5. Will the credit risk resulting from funds transfers have an adverse impact on overall asset quality?
6. Does the allowance for loan and lease losses adequately include significant adverse credit risk that is derived from EFT activities?
7. Will the weaknesses identified from the review of payment systems risk and EFT activity have a negative impact on overall liquidity, earnings, or capital?

The role of bank regulators in supervising private-banking activities is (1) to evaluate management's ability to measure and control the risks associated with such activities and (2) to determine if the proper internal control and audit infrastructures are in place to support effective compliance with relevant laws and regulations. In this regard, the supervisors may determine that certain risks have not been identified or adequately managed by the institution, a potentially unsafe and unsound banking practice.

Private-banking functions may be performed in a specific department of a commercial bank, an Edge corporation or its foreign subsidiaries, a nonbank subsidiary, a branch or agency of a foreign banking organization, or multiple areas of an institution. Private banking may also be the sole business of an institution. Regardless of how an institution is organized or where it is located, the results of the private-banking review should be reflected in the entity's overall supervisory assessment.<sup>1</sup>

This section provides examiners with guidance for reviewing private-banking activities at all types and sizes of financial institutions. It is intended to supplement, not replace, existing guidance on the examination of private-banking activities and to broaden the examiner's review of general risk-management policies and practices governing private-banking activities. In addition to providing an overview of private banking, the general types of customers, and the various products and services typically provided, the "Functional Review" subsection describes the critical functions that constitute a private-banking operation and identifies certain safe and sound banking practices. These critical functions are supervision and organization, risk management, fiduciary standards, operational controls, management information systems, audit, and compliance. Included in the risk-management portion is a discussion of the basic "customer-due-diligence" (CDD) principle that is the foundation for the safe and sound operation of a private-banking business. The "Preparation for Examination" subsection assists in defining the examination scope and provides a

list of core requests to be made in the first-day letter. Additional examination guidance can be found in this manual, the Federal Financial Institutions Examination Council's (FFIEC) *Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual*, the Federal Reserve System's *Trading and Capital-Markets Activities Manual*, and the FFIEC *Information Technology Examination Infobase*.

In reviewing specific functional and product-examination procedures (as found in the private-banking activities module that is part of the framework for risk-focused supervision of large complex institutions), all aspects of the private-banking review should be coordinated with the rest of the examination to eliminate unnecessary duplication of effort. Furthermore, this section has introduced the review of trust activities and fiduciary services, critical components of most private-banking operations, as part of the overall private-banking review. Although the product nature of these activities differs from that of products generated by other banking activities, such as lending and deposit taking, the functional components of private banking (supervision and organization, risk management, operational controls and management information systems, audit, compliance, and financial condition/business profile) should be reviewed across product lines.

Private banking offers the personal and discrete delivery of a wide variety of financial services and products to an affluent market, primarily to high net worth individuals and their corporate interests. A private-banking operation typically offers its customers an all-inclusive money-management relationship, including investment portfolio management, financial-planning advice, offshore facilities, custodial services, funds transfer, lending services, overdraft privileges, hold mail, letter-of-credit financing, and bill-paying services. As the affluent market grows, both in the United States and globally, competition to serve it is becoming more intense. Consequently, the private-banking marketplace includes banks, nonbanks, and other types of banking organizations and financial institutions. Private-banking products, services, technologies, and distribution channels are still evolving. A range of private-banking products and services may be offered to customers throughout an institution's global network of affiliated entities—including branches, subsidi-

1. Throughout this section, the word *bank* will be used to describe all types of financial institutions, and the term *board of directors* will be interchangeable with *senior management* of branches and agencies of foreign banks.

aries, and representative offices—in many different regions of the world, including offshore secrecy jurisdictions.

Typically, private-banking customers are high net worth individuals or institutional investors who have minimum investible assets of \$1 million or more. Institutions often differentiate domestic from international private banking, and they may further segregate the international function on the basis of the geographic location of their international client base. International private-banking clients may be wealthy individuals who live in politically unstable nations and are seeking a safe haven for their capital. Therefore, obtaining detailed background information and documentation about the international client may be more difficult than it is for the domestic customer. Private-banking accounts may, for example, be opened in the name of an individual, a commercial business, a law firm, an investment adviser, a trust, a personal investment company (PIC), or an offshore mutual fund.

In 2001, the USA PATRIOT Act (the Patriot Act) established new and enhanced measures to prevent, detect, and prosecute money laundering and terrorist financing. In general, these measures were enacted through amendments to the Bank Secrecy Act (BSA). The measures directly affecting banking organizations are implemented primarily through regulations issued by the U.S. Department of the Treasury (31 CFR 1010).<sup>2</sup> Section 326 of the Patriot Act (see the BSA at 31 USC 5318(l)) requires financial institutions (such as banks, savings associations, and credit unions) to have customer identification programs that include measures to—

- require that certain information be obtained at account opening (for individuals, the information would generally include their name, address, tax identification number, and date of birth);
- verify the identity of new account holders within a reasonable time period;
- ensure that a banking organization has a

reasonable belief that it knows each customer's identity;

- maintain records of the information used to verify a person's identity; and
- compare the names of new customers against government lists of known or suspected terrorists or terrorist organizations.

A customer identification program is an important component of a financial institution's overall anti-money-laundering and BSA compliance program.

The FFIEC *BSA/AML Examination Manual* provides the interagency BSA examination procedures that should be used to evaluate banking organizations' compliance with the regulation. The examination's scope can be tailored to the reliability of the banking organization's compliance-management system and to the level of risk that the organization assumes. Relevant interagency guidance (in a frequently-asked-question format) has been issued to address the customer identification program rules. (See SR-05-9.)

Private-banking accounts are usually generated on a referral basis. Every client of a private-banking operation is assigned a salesperson or marketer, commonly known as a relationship manager (RM), as the primary point of contact with the institution. The RM is generally charged with understanding and anticipating the needs of his or her wealthy clients and then recommending services and products for them. The number of accounts an RM handles varies, depending on the portfolio size or net worth of the particular accounts. RMs strive to provide a high level of support, service, and investment opportunities to their clients and tend to maintain strong, long-term client relationships. Frequently, RMs take accounts with them to other private-banking institutions if they change employment. Historically, initial and ongoing due diligence of private-banking clients is not always well documented in the institution's files because of RM turnover and confidentiality concerns.

Clients may choose to delegate a great deal of authority and discretion over their financial affairs to RMs. Given the close relationship between clients and their account officers, an integral part of the examination process is assessing the adequacy of managerial oversight of the nature and volume of transactions conducted within the private-banking department or with other departments of the financial institu-

2. For banking organizations, the regulation implementing the requirements of section 326 of the Patriot Act was jointly issued by the U.S. Department of the Treasury, through the Financial Crimes Enforcement Network (FinCEN), and the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

tion, as well as determining the adequacy and integrity of the RM's procedures. Policy guidelines and management supervision should provide parameters for evaluating the appropriateness of all products, especially those involving market risk. Moreover, because of the discretion given to RMs, management should develop effective procedures to review the activity of client accounts in order to protect the client from any unauthorized activity. In addition, ongoing monitoring of account activity should be conducted to detect activity that is inconsistent with the client profile (for example, frequent or sizable unexplained transfers flowing through the account).

Finally, as clients develop a return-on-assets (ROA) outlook to enhance their returns, the use of leveraging and arbitrage is becoming more evident in the private-banking business. Examiners should be alert to the totality of the client relationship product by product, in light of increasing client awareness and use of derivatives, emerging-market products, foreign exchange, and margined accounts.

## Products and Services

### *Personal Investment Companies, Offshore Trusts, and Token-Name Accounts*

Private-banking services almost always involve a high level of confidentiality for clients and their account information. Consequently, it is not unusual for private bankers to help their clients achieve their financial-planning, estate-planning, and confidentiality goals through offshore vehicles such as personal investment companies (PICs), trusts, or more-exotic arrangements, such as hedge fund partnerships. While these vehicles may be used for legitimate reasons, without careful scrutiny, they may camouflage illegal activities. Private bankers should be committed to using sound judgment and enforcing prudent banking practices, especially when they are assisting clients in establishing offshore vehicles or token-name accounts.

Through their global network of affiliated entities, private banks often form PICs for their clients. These "shell" companies, which are incorporated in offshore secrecy jurisdictions such as the Cayman Islands, Channel Islands, Bahamas, British Virgin Islands, and Netherlands Antilles, are formed to hold the customer's assets as well as offer confidentiality by opening

accounts in the PIC's name. The "beneficial owners" of the shell corporations are typically foreign nationals. The banking institution should know and be able to document that it knows the beneficial owners of such corporations and that it has performed the appropriate due diligence to support these efforts. Emphasis should be placed on verifying the source or origin of the customer's wealth. Similarly, offshore trusts established in these jurisdictions should identify grantors of the trusts and sources of the grantors' wealth. *Anonymous relationships or relationships in which the RM does not know and document the beneficial owner should not be permitted.*

PICs are typically passive personal investment vehicles. However, foreign nationals have established PICs as operating accounts for business entities they control in their home countries. Accordingly, financial institutions should use extra care when dealing with beneficial owners of PICs and associated trusts; these vehicles can be used to conceal illegal activities.

### *Deposit Taking*

A client's private-banking relationship frequently begins with a deposit account and then expands into other products. In fact, many institutions require private-banking customers to establish a deposit account before maintaining any other accounts. Deposit accounts serve as conduits for a client's money flows. To distinguish private-banking accounts from retail accounts, institutions usually require significantly higher minimum account balances and assess higher fees. The private-banking function or institution should have account-opening procedures and documentation requirements that must be fulfilled before a deposit account can be opened. (These standards are described in detail in the "Functional Review" subsection.)

Most private banks offer a broad spectrum of deposit products, including multicurrency deposit accounts that are used by clients who engage in foreign-exchange, securities, and derivatives transactions. The client's transaction activity, such as wire transfers, check writing, and cash deposits and withdrawals, is conducted through deposit accounts (including current accounts). It is very important that the transaction activity into and out of these deposit accounts (including internal transfers between affiliated depository accounts) be closely monitored for suspicious

transactions that are inconsistent with the client's profile of usual transactions. Suspicious transactions could warrant the filing of a Suspicious Activity Report for Depository Institutions (SAR) form. A bank holding company or any nonbank subsidiary thereof, or a foreign bank that is subject to the Bank Holding Company Act (or any nonbank subsidiary of such a foreign bank operating in the United States), is required to file a SAR form in accordance with the provision of section 208.62 of the Federal Reserve Board's Regulation H (12 CFR 208.62) when suspicious transactions or activities are initially discovered and warrant or require reporting. See the expanded procedures for private banking in the FFIEC's *BSA/AML Examination Manual*.

On March 15, 2006, the Board approved a revision to Regulation K (effective April 19, 2006) that incorporates by reference into sections 211.5 and 211.24 of Regulation K section 208.63 of Regulation H. The incorporation results in the requirement that Edge and agreement corporations and other foreign banking organizations (that is, Federal Reserve supervised U.S. branches, agencies, and representative offices of foreign banks) must establish and maintain procedures reasonably designed to ensure and monitor compliance with the BSA and related regulations. Each of these banking organizations' compliance programs must include, at a minimum (1) a system of internal controls to ensure ongoing compliance, (2) independent testing of compliance by the institution's personnel or by an outside party, (3) the designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance, and (4) training for appropriate personnel. (See SR-06-7.)

### *Investment Management*

In private banking, investment management usually consists of two types of accounts: (1) discretionary accounts in which portfolio managers make the investment decisions on the basis of recommendations from the bank's investment research resources and (2) nondiscretionary (investment advisory) accounts in which clients make their own investment decisions when conducting trades. For nondiscretionary clients, the banks typically offer investment recommendations subject to the client's written approval. Discretionary accounts consist of a mixture of

instruments bearing varying degrees of market, credit, and liquidity risk that should be appropriate to the client's investment objectives and risk appetite. Both account types are governed under separate agreements between the client and the institution.

Unlike depository accounts, securities and other instruments held in the client's investment accounts are not reflected on the balance sheet of the institution because they belong to the client. These managed assets are usually accounted for on a separate ledger that is segregated according to the customer who owns the assets.

### *Credit*

Private-banking clients may request extensions of credit on either a secured or an unsecured basis. Loans backed by cash collateral or managed assets held by the private-banking function are quite common, especially in international private banking. Private-banking clients may pledge a wide range of their assets, including cash, mortgages, marketable securities, land, or buildings, to securitize their loans. Management should demonstrate an understanding of the purpose of the credit, the source of repayment, the loan tenor, and the collateral used in the financing. When lending to individuals with high net worths, whether on a secured or an unsecured basis, the creditworthiness determination is bolstered by a thorough and well-structured customer-due-diligence process. If that process is not thorough, collateral derived from illicit activities may be subject to government forfeiture.

Borrowing mechanisms are sometimes established to afford nonresident-alien customers the ability to keep financial assets in the United States and to use such assets (via collateralized borrowing arrangements) to provide operating capital for businesses they own and operate in their home countries. Such arrangements enable these customers to keep the existence of the financial assets secret from their home-country authorities and others, while they continue to use the funds (via collateralized borrowings) to fund the businesses at home.

Private bankers need to maintain in the United States adequate CDD information on such nonresident-alien customers and their primary business interests. A well-documented CDD file may include information on the customer from

“who’s who” and similar services, Internet research, foreign tax returns and financial statements, checks conducted by the Office of Foreign Assets Control (OFAC), and written and appropriately documented Call Reports prepared by the RM.

While these lending mechanisms may be used for legitimate reasons, management needs to determine whether the arrangements are being used primarily to obfuscate the beneficial ownership of collateral assets, making it difficult for the customer’s home-country government to identify who owns the assets. If so, management needs to further determine whether the practice varies from both the appropriate standards of international cooperation for transparency issues and with prudent banking practices, and if so, whether the institution is exposed to elevated legal risk.

### *Payable-Through Accounts*

Another product that may be available in private-banking operations is payable-through accounts (PTAs). PTAs are transaction deposit accounts through which U.S. banking entities (“payable-through banks”) extend check-writing privileges to the customers of a foreign bank. The foreign bank (“master account holder”) opens a master checking account with the U.S. bank and uses this account to provide its customers with access to the U.S. banking system. The master account is divided into “subaccounts,” each in the name of one of the foreign bank’s customers. The foreign bank extends signature authority on its master account to its own customers, who may not be known to the U.S. bank. Consequently, the U.S. bank may have customers who have not been subject to the same account-opening requirements imposed on its U.S. account holders. These subaccount customers are able to write checks and make deposits at the U.S. banking entity. The number of subaccounts permitted under this arrangement may be virtually unlimited.

U.S. banking entities engage in PTAs primarily because they attract dollar deposits from the domestic market of their foreign correspondents without changing the primary bank-customer relationship; PTAs also provide substantial fee income. Generally, PTAs at U.S. banking entities have the following characteristics: they are carried on the U.S. banking entity’s books as a correspondent bank account, their transaction

volume is high, checks passing through the account contain wording similar to “payable through XYZ bank,” and the signatures appearing on checks are not those of authorized officers of the foreign bank. See the expanded examination procedures for PTAs in the FFIEC’s *BSA/AML Examination Manual*.

### *Personal Trust and Estates*

In trust and estate accounts, an institution offers management services for a client’s assets. When dealing with trusts under will, or “testamentary trusts,” the institution may receive an estate appointment (executor) and a trustee appointment if the will provided for the trust from the probate. These accounts are fully funded at origination with no opportunity for an outside party to add to the account, and all activities are subject to review by the probate or surrogates’ court. On the other hand, with living trusts, or “grantor trusts,” the customer (grantor) may continually add to and, in some instances, has control over the corpus of the account. Trusts and estates require experienced attorneys, money managers, and generally well-rounded professionals to set up and maintain the accounts. In certain cases, bankers may need to manage a customer’s closely held business or sole proprietorship. In the case of offshore trust facilities, recent changes in U.S. law have imposed additional obligations on those banks that function as trustees or corporate management for offshore trusts and PICs.

A critical element in offering personal trust and estate services is the fiduciary responsibility of the institutions to their customers. This responsibility requires that institutions always act in the best interest of the clients pursuant to the trust documentation, perhaps even to the detriment of the bank. In these accounts, the bank is the fiduciary and the trust officer serves as a representative of the institution. Fiduciaries are held to higher standards of conduct than other bankers. Proper administration of trusts and estates includes strict controls over assets, prudent investment and management of assets, and meticulous recordkeeping. See the expanded examination procedures for trust and asset-management services in the FFIEC’s *BSA/AML Examination Manual*.



### *Custody Services*

Custodial services offered to private-banking customers include securities safekeeping, receipt and disbursement of dividends and interest, recordkeeping, and accounting. Custody relationships can be established in many ways, including by referrals from other departments in the bank or from outside investment advisers. The customer or a designated financial adviser retains full control of the investment management of the property subject to the custodianship. Sales and purchases of assets are made by instruction from the customer, and cash disbursements are prearranged or as instructed. Custody accounts involve no investment supervision and no discretion. However, the custodian may be responsible for certain losses if it fails to act properly according to the custody agreement. Therefore, procedures for proper administration should be established and reviewed.

An escrow account is a form of custody account in which the institution agrees to hold cash or securities as a middleman, or a third party. The customer, for example, an attorney or a travel agency, gives the institution funds to hold until the ultimate receiver of the funds “performs” in accordance with the written escrow agreement, at which time the institution releases the funds to the designated party.

### *Funds Transfer*

Funds transfer, another service offered by private-banking functions, may involve the transfer of funds between third parties as part of bill-paying and investment services on the basis of customer instructions. The adequacy of controls over funds-transfer instructions that are initiated electronically or telephonically is extremely important. Funds-transfer requests are quickly processed and, as required by law, funds-transfer personnel may have limited knowledge of the customers or the purpose of the transactions. Therefore, strong controls and adequate supervision over this area are critical. See section 4063.1.

### *Hold Mail, No Mail, and Electronic-Mail Only*

Hold-mail, no-mail, or electronic-mail-only accounts are often provided to private-banking

customers who elect to have bank statements and other documents maintained at the institution rather than mailed to their residence. Agreements for hold-mail accounts should be in place, and the agreements should indicate that it was the customer’s choice to have the statements retained at the bank and that the customer will pick up his or her mail at least annually. Variations of hold-mail services include delivery of mail to a prearranged location (such as another branch of the bank) by special courier or the bank’s pouch system.

### *Bill-Paying Services*

Bill-paying services are often provided to private-banking customers for a fee. If this service is provided, an agreement between the bank and the customer should exist. Typically, a customer may request that the bank debit a deposit account for credit card bills, utilities, rent, mortgage payments, or other monthly consumer charges. In addition, the increased use of the Internet has given rise to the “electronic-mail-only” account, whereby customers elect to have statements, notices, etc., sent to them only by e-mail.

## FUNCTIONAL REVIEW

When discussing the functional aspects of a private-banking operation, *functional* refers to managerial processes and procedures, such as reporting lines, quality of supervision (including involvement of the board of directors), information flows, policies and procedures, risk-management policies and methodologies, segregation of duties, management information systems, operational controls (including BSA/AML monitoring), and audit coverage. The examiner should be able to draw sound conclusions about the quality and culture of management and stated private-banking policies after reviewing the functional areas described below. Specifically, the institution’s risk-identification process and risk appetite should be carefully defined and assessed. Additionally, the effectiveness of the overall control environment maintained by management should be evaluated by an internal or external audit. The effectiveness of the following functional areas is critical to any private-

banking operation, regardless of its size or product offerings.

## Supervision and Organization

As part of the examiner's appraisal of an organization, the quality of supervision of private-banking activities is evaluated. The appraisal of management covers the full range of functions and activities related to the operation of the private bank. The discharge of responsibilities by bank directors should be effected through an organizational plan that accommodates the volume and business services handled, local business practices and the bank's competition, and the growth and development of the institution's private-banking business. Organizational planning is the joint responsibility of senior bank and private-bank management, should be integrated with the long-range plan for the institution, and should be consistent with any enterprise-wide-risk-management program.

Both the directors and management have important roles in formulating policies and establishing programs for private-banking products, operations, internal controls, and audits. However, management alone must implement policies and programs within the organizational framework instituted by the board of directors.

## Risk Management

Sound risk-management processes and strong internal controls are critical to safe and sound banking generally and to private-banking activities in particular. Management's role in ensuring the integrity of these processes has become increasingly important as new products and technologies are introduced. Similarly, the client-selection, documentation, approval, and account-monitoring processes should adhere to sound and well-identified practices.

The quality of risk-management practices and internal controls is given significant weight in the evaluation of management and the overall condition of private-banking operations. A bank's failure to establish and maintain a risk-management framework that effectively identifies, measures, monitors, and controls the risks associated with products and services should be considered unsafe and unsound conduct. Furthermore, well-defined management practices

should indicate the types of clients that the institution will and will not accept and should establish multiple and segregated levels of authorization for accepting new clients. Institutions that follow sound practices will be better positioned to design and deliver products and services that match their clients' legitimate needs, while reducing the likelihood that unsuitable clients might enter their client account base. Deficiencies noted in this area are weighted in context of the relative risk they pose to the institution and are appropriately reflected in the appraisal of management.

The private-banking function is exposed to a number of risks, including reputational, fiduciary, legal, credit, operational, and market. A brief description of some of the different types of risks follows:

- *Reputational risk* is the potential that negative publicity regarding an institution's business practices and clients, whether true or not, could cause a decline in the customer base, costly litigation, or revenue reductions.
- *Fiduciary risk* refers to the risk of loss due to the institution's failure to exercise loyalty; safeguard assets; and, for trusts, to use assets productively and according to the appropriate standard of care. This risk generally exists in an institution to the extent that it exercises discretion in managing assets on behalf of a customer.
- *Legal risk* arises from the potential of unenforceable contracts, client lawsuits, or adverse judgments to disrupt or otherwise negatively affect the operations or condition of a banking organization. One key dimension of legal risk is supervisory action that could result in costly fines or other punitive measures being levied against an institution for compliance breakdowns.
- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.

Although effective management of all of the above risks is critical for an institution, certain aspects of reputational, legal, and fiduciary risks are often unique to a private-banking function. In this regard, the following customer-due-



diligence policies and practices are essential in the management of reputational and legal risks in the private-banking functions. (In addition, sound fiduciary practices and conflicts-of-interest issues that a private-banking operation may face in acting as fiduciary are described in the subsection on fiduciary standards.)

### *Customer-Due-Diligence Policy and Procedures*

Sound customer-due-diligence (CDD) policies and procedures are essential to minimize the risks inherent in private banking. The policies and procedures should clearly describe the target client base in terms such as “minimum investable net worth” and “types of products sought,” as well as specifically indicate the type of clientele the institution will or will not accept. Policies and procedures should be designed to ensure that effective due diligence is performed on all potential clients, that client files are bolstered with additional CDD information on an ongoing basis, and that activity in client accounts is monitored for transactions that are inconsistent with the client profile and may constitute unlawful activities, such as money laundering. The client’s identity, background, and the nature of his or her transactions should be documented and approved by the back office before opening an account or accepting client monies. Certain high-risk clients like foreign politicians or money exchange houses should have additional documentation to mitigate their higher risk.

Money laundering is associated with a broad range of illicit activities: the ultimate intention is to disguise the money’s true source—from the initial placement of illegally derived cash proceeds to the layers of financial transactions that disguise the audit trail—and make the funds appear legitimate. Under U.S. money-laundering statutes, a bank employee can be held personally liable if he or she is deemed to engage in “willful blindness.” This condition occurs when the employee fails to make reasonable inquiries to satisfy suspicions about client account activities.

Since the key element of an effective CDD policy is a comprehensive knowledge of the client, the bank’s policies and procedures should clearly reflect the controls needed to ensure the policy is fully implemented. CDD policies should clearly delineate the accountability and author-

ity for opening accounts and for determining if effective CDD practices have been performed on each client. In addition, policies should delineate documentation standards and accountability for gathering client information from referrals among departments or areas within the institution as well as from accounts brought to the institution by new RMs.

In carrying out prudent CDD practices on potential private-banking customers, management should document efforts to obtain and corroborate critical background information. Private-banking employees abroad often have local contacts who can assist in corroborating information received from the customer. The information listed below should be corroborated by a reliable, independent source, when possible:

- The customer’s current address and telephone number for his or her primary residence, which should be corroborated at regular intervals, can be verified through a variety of methods, such as—
  - visiting the residence, office, factory, or farm (with the RM recording the results of the visit or conversations in a memorandum);
  - checking the information against the telephone directory; the client’s residence, as indicated on his or her national ID card; a mortgage or bank statement or utility or property tax bill; or the electoral or tax rolls;
  - obtaining a reference from the client’s government or known employer or from another bank;
  - checking with a credit bureau or professional corroboration organization; or
  - any other method verified by the RM.
- Sufficient business information about the customer should be gathered so that the RM understands the profile of the customer’s commercial transactions. This information should include a description of the nature of the customer’s business operations or means of generating income, primary trade or business areas, and major clients and their geographic locations, as well as the primary business address and telephone number. These items can be obtained through a combination of any of the following sources:
  - a visit to the office, factory, or farm
  - a reliable third party who has a business relationship with the customer
  - financial statements

- Dun and Bradstreet reports
- newspaper or magazine articles
- LexisNexis reports on the customer or customer's business
- "Who's Who" reports from the home country
- private investigations
- Although it is often not possible to get proof of a client's wealth, the RM can use his or her good judgment to derive a reasonable estimate of the individual's net worth.
- As part of the ongoing CDD process, the RM should document in memos or "call reports" the substance of discussions that take place during frequent visits with the client. Additional information about a client's wealth, business, or other interests provides insight into potential marketing opportunities for the RM and the bank, and updates and strengthens the CDD profile.

As a rule, most private banks make it a policy not to accept walk-in clients. If an exception is made, procedures for the necessary documentation and approvals supporting the exception should be in place. Similarly, other exceptions to policy and procedures should readily identify the specific exception and the required due-diligence and approval process for overriding existing procedures.

In most instances, all CDD information and documentation should be maintained and available for examination and inspection at the location where the account is located or where the financial services are rendered. If the bank maintains centralized customer files in locations other than where the account is located or where the financial services are rendered, complete customer information, identification, and documentation must be made available at the location where the account is located or where the financial services are rendered within 48 hours of a Federal Reserve examiner's request. Off-site storage of CDD information will be allowed only if the bank has adopted, as part of its customer-due-diligence program, specific procedures designed to ensure that (1) the accounts are subject to ongoing Office of Foreign Assets Control screening that is equivalent to the screening afforded other accounts, (2) the accounts are subject to the same degree of review for suspicious activity, and (3) the bank demonstrates that the appropriate review of the information and documentation is being performed by personnel at the offshore location.

CDD procedures should be no different when the institution deals with a financial adviser or other type of intermediary acting on behalf of a client. To perform its CDD responsibilities when dealing with a financial adviser, the institution should identify the beneficial owner of the account (usually the intermediary's client, but in rare cases, it is the intermediary itself) and perform its CDD analysis with respect to that beneficial owner. The imposition of an intermediary between the institution and counterparty should not lessen the institution's CDD responsibilities.

The purpose of all private-banking relationships should also be readily identified. Incoming customer funds may be used for various purposes, such as establishing deposit accounts, funding investments, or establishing trusts. The bank's CDD procedures should allow for the collection of sufficient information to develop a transaction or client profile for each customer, which will be used in analyzing client transactions. Internal systems should be developed for monitoring and identifying transactions that may be inconsistent with the transaction or client profile for a customer and which may thus constitute suspicious activity.

*Suspicious Activity Reports by Depository Institutions.* The proper and timely filing of Suspicious Activity Report (SAR) forms is an important component of a bank's CDD program. Since 1996, the federal financial institution supervisory agencies and the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) have required banking organizations to report known or suspected violations of law as well as suspicious transactions on a suspicious activity report or SAR form. See the Board's SAR form regulation (Regulation H, section 208.62 (12 CFR 208.62)).<sup>3</sup> Law enforcement agencies use the information reported on the form to initiate investigations, and Federal Reserve staff use the SAR form information in their examination and oversight of supervised institutions.

A member bank is required to file a SAR form with the appropriate federal law enforcement agencies and the Department of the Treasury. A

3. The Board's SAR form rules apply to state member banks, bank holding companies and their nonbank subsidiaries that do not report on a different SAR form (for example, broker-dealers), Edge and agreement corporations, and the U.S. branches and agencies of foreign banks supervised by the Federal Reserve.

SAR form must be prepared in accordance with the form's instructions and is to be sent to FinCEN when an institution detects—

- insider abuse involving any amount,
- violations aggregating \$5,000 or more in which a suspect can be identified,
- violations aggregating \$25,000 or more regardless of a potential suspect, or
- transactions aggregating \$5,000 or more that involve potential money laundering or violations of the Bank Secrecy Act.

When a SAR form is filed, the management of a member bank must promptly notify its board of directors or a committee thereof.

A SAR form must be filed within 30 calendar days after the date of initial detection of the facts that may constitute a basis for filing a SAR form. If no suspect was identified on the date of detection of the incident requiring the filing, a member bank may delay filing a SAR form for an additional 30 calendar days in order to identify the suspect. Reporting may not be delayed more than 60 calendar days after the date of initial detection of a reportable transaction. In situations involving violations requiring immediate attention, such as when a reportable violation is ongoing, the financial institution is required to immediately notify an appropriate law enforcement authority in addition to its timely filing of a SAR form.

A bank's internal systems for capturing suspicious activities should provide essential information about the nature and volume of activities passing through customer accounts. Any information suggesting that suspicious activity has occurred should be pursued, and, if an explanation is not forthcoming, the matter should be reported to the bank's management. Examiners should ensure that the bank's approach to SAR forms is proactive and that well-established procedures cover the SAR form process. Accountability should exist within the organization for the analysis and follow-up of internally identified suspicious activity; this analysis should conclude with a decision on the appropriateness of filing a SAR form. See the core procedures concerning suspicious-activity-reporting requirements in the FFIEC *BSA/AML Examination Manual*.

### *Credit-Underwriting Standards*

The underwriting standards for private-banking loans to high net worth individuals should be consistent with prudent lending standards. The same credit policies and procedures that are applicable to any other type of lending arrangement should extend to these loans. At a minimum, sound policies and procedures should address the following: all approved credit products and services offered by the institution, lending limits, acceptable forms of collateral, geographic and other limitations, conditions under which credit is granted, repayment terms, maximum tenor, loan authority, collections and charge-offs, and prohibition against capitalization of interest.

An extension of credit based solely on collateral, even if the collateral is cash, does not ensure repayment. While the collateral enhances the bank's position, it should not substitute for regular credit analyses and prudent lending practices. If collateral is derived from illegal activities, it is subject to forfeiture through the seizure of assets by a government agency. The bank should perform its due diligence by adequately and reasonably ascertaining and documenting that the funds of its private-banking customers were derived from legitimate means. Banks should also verify that the use of the loan proceeds is for legitimate purposes.

In addition, bank policies should explicitly describe the terms under which "margin loans," loans collateralized by securities, are made and should ensure that they conform to applicable regulations. Management should review and approve daily MIS reports. The risk of market deterioration in the value of the underlying collateral may subject the lender to loss if the collateral must be liquidated to repay the loan. In the event of a "margin call," any shortage should be paid for promptly by the customer from other sources pursuant to the terms of the margin agreement.

In addition, policies should address the acceptance of collateral held at another location, such as an affiliated entity, but pledged to the private-banking function. Under these circumstances, management of the private-banking function should, at a minimum, receive frequent reports detailing the collateral type and current valuation. In addition, management of the private-banking function should be informed of any changes or substitutions in collateral.

## Fiduciary Standards

Fiduciary risk is managed through the maintenance of an effective and accountable committee structure; retention of technically proficient staff; and development of effective policies, procedures, and controls. In managing its fiduciary risk, the bank must ensure that it carries out the following fiduciary duties:

- *Duty of loyalty.* Trustees are obligated to make all decisions based exclusively on the best interests of trust customers. Except as permitted by law, trustees cannot place themselves in a position in which their interests might conflict with those of the trust beneficiaries.
- *Avoidance of conflicts of interest.* Conflicts of interest arise in any transaction in which the fiduciary simultaneously represents the interests of multiple parties (including its own interests) that may be adverse to one another. Institutions should have detailed policies and procedures regarding potential conflicts of interest. All potential conflicts identified should be brought to the attention of management and the trust committee, with appropriate action taken. Conflicts of interest may arise throughout an institution. Care should be taken by fiduciary business lines, in particular, to manage conflicts of interest between fiduciary business lines and other business lines (including other fiduciary business lines). Consequently, management throughout the institution should receive training in these matters. For more information on the supervision of fiduciary activities, see section 4200.0 in this manual and section 3120.0 of the *Bank Holding Company Supervision Manual*.
- *Duty to prudently manage discretionary trust and agency assets.* Since 1994, the majority of states have adopted laws concerning the prudent investor rule (PIR) with respect to the investment of funds in a fiduciary capacity. PIR is a standard of review that imposes an obligation to prudently manage the portfolio as a whole, focusing on the process of portfolio management, rather than on the outcome of individual investment decisions. Although this rule only governs trusts, the standard is traditionally applied to all accounts for which the institution is managing funds.

## Operational Controls

To minimize any operational risks associated with private-banking activities, management is responsible for establishing an effective internal control infrastructure and reliable management information systems. Critical operational controls over any private-banking activity include the establishment of written policies and procedures, segregation of duties, and comprehensive management reporting. Throughout this section, specific guidelines and examination procedures for assessing internal controls over different private-banking activities are provided. Listed below are some of those guidelines that cover specific private-banking services.

### *Segregation of Duties*

Banking organizations should have guidelines on the segregation of employees' duties in order to prevent the unauthorized waiver of documentation requirements, poorly documented referrals, and overlooked suspicious activities. Independent oversight by the back office helps to ensure compliance with account-opening procedures and CDD documentation. Control-conscious institutions may use independent units, such as compliance, risk management, or senior management to fill this function in lieu of the back office. The audit and compliance functions of the private-banking entity should be similarly independent so that they can operate autonomously from line management.

### *Inactive and Dormant Accounts*

Management should be aware that banking laws in most states prohibit banks from offering services that allow deposit accounts to be inactive for prolonged periods of time (generally, 12 or more months with no externally generated account-balance activity). These regulations are based on the presumption that inactive and dormant accounts may be subject to manipulation and abuse by insiders. Policies and procedures should delineate when inactivity occurs and when inactive accounts should be converted to dormant status. Effective controls over dormant accounts should include a specified time between the last customer-originated activity and its classification as dormant, the segregation

of signature cards for dormant accounts, dual control of records, and the blocking of the account so that entries cannot be posted to the account without review by more than one member of senior management.

### *Pass-Through Accounts and Omnibus Accounts*

Pass-through accounts (PTAs) extend checking-account privileges to the customers of a foreign bank; several risks are involved in providing these accounts. In particular, if the U.S. banking entity does not exercise the same due diligence and customer vetting for PTAs as it does for domestic account relationships, the use of PTAs may facilitate unsafe and unsound banking practices or illegal activities, including money laundering. Additionally, if accounts at U.S. banking entities are used for illegal purposes, the entities could be exposed to reputational risk and risk of financial loss as a result of asset seizures and forfeitures brought by law enforcement authorities. It is recommended that U.S. banking entities terminate a payable-through arrangement with a foreign bank in situations in which (1) adequate information about the ultimate users of PTAs cannot be obtained, (2) the foreign bank cannot be relied on to identify and monitor the transactions of its own customers, or (3) the U.S. banking entity is unable to ensure that its payable-through accounts are not being used for money laundering or other illicit purposes.

*Omnibus*, or general clearing, accounts may also exist in the private-banking system. They may be used to accommodate client funds before an account opening to expedite a new relationship, or they may fund products such as mutual funds in which client deposit accounts may not be required. However, these accounts could circumvent an audit trail of client transactions. Examiners should carefully review a bank's use of such accounts and the adequacy of its controls on their appropriate use. Generally, client monies should flow through client deposit accounts, which should function as the sole conduit and paper trail for client transactions.

### *Hold-Mail, No Mail, and E-mail-Only Controls*

Controls over hold-mail, no-mail, and e-mail-only accounts are critical because the clients have relinquished their ability to detect unauthorized transactions in their accounts in a timely manner. Accounts with high volume or significant losses warrant further inquiry. Hold-mail, no-mail, and e-mail-only account operations should ensure that client accounts are subject to dual control and are reviewed by an independent party.

### *Funds Transfer—Tracking Transaction Flows*

One way that institutions can improve their customer knowledge is by tracking the transaction flows into and out of customer accounts and payable-through subaccounts. Tracking should include funds-transfer activities. Policies and procedures to detect unusual or suspicious activities should identify the types of activities that would prompt staff to investigate the customer's activities and should provide guidance on the appropriate action required for suspicious activity. The following is a checklist to guide bank personnel in identifying some potential abuses:

- indications of frequent overrides of established approval authority or other internal controls
- intentional circumvention of approval authority by splitting transactions
- wire transfers to and from known secrecy jurisdictions
- frequent or large wire transfers for persons who have no account relationship with the bank, or funds being transferred into and out of an omnibus or general clearing account instead of the client's deposit account
- wire transfers involving cash amounts in excess of \$10,000
- inadequate control of password access
- customer complaints or frequent error conditions

### *Custody—Detection of Free Riding*

Custody departments should monitor account activity to detect instances of *free-riding*, the



practice of offering the purchase of securities without sufficient capital and then using the proceeds of the sale of the same securities to cover the initial purchase. Free-riding poses significant risk to the institution and typically occurs without the bank's prior knowledge. Free-riding also violates margin rules (Regulations T, U, and X) governing the extension of credit in connection with securities transactions. (See SR-93-13.)

## Management Information Systems

Management information systems (MIS) should accumulate, interpret, and communicate information on (1) the private-banking assets under management, (2) profitability, (3) business and transaction activities, and (4) inherent risks. The form and content of MIS for private-banking activities will be a function of the size and complexity of the private-banking organization. Accurate, informative, and timely reports that perform the following functions may be prepared and reviewed by RMs and senior management:

- aggregate the assets under management according to customer, product or service, geographic area, and business unit
- attribute revenue according to customer and product type
- identify customer accounts that are related to or affiliated with one another through common ownership or common control
- identify and aggregate customer accounts by source of referral
- identify beneficial ownership of trust, PIC, and similar accounts

To monitor and report transaction activity and to detect suspicious transactions, management reports may be developed to—

- monitor a specific transaction criterion, such as a minimum dollar amount or volume or activity level;
- monitor a certain type of transaction, such as one with a particular pattern;
- monitor individual customer accounts for variations from established transaction and activity profiles based on what is usual or expected for that customer; and
- monitor specific transactions for BSA and

SAR form compliance.

In addition, reports prepared for private-banking customers should be accurate, timely, and informative. Regular reports and statements prepared for private-banking customers should adequately and accurately describe the application of their funds and should detail all transactions and activity that pertain to the customers' accounts.

Furthermore, MIS and technology play a role in building new and more direct channels of information between the institution and its private-banking customers. Active and sophisticated customers are increasing their demand for data relevant to their investment needs, which is fostering the creation of online information services. Online information can satisfy customers' desire for convenience, real-time access to information, and a seamless delivery of information.

## Audit

An effective audit function is vital to ensuring the strength of a private bank's internal controls. As a matter of practice, internal and external auditors should be independently verifying and confirming that the framework of internal controls is being maintained and operated in a manner that adequately addresses the risks associated with the activities of the organization. Critical elements of an effective internal audit function are the strong qualifications and expertise of the internal audit staff and a sound risk-assessment process for determining the scope and frequency of specific audits. The audit process should be risk-focused and should ultimately determine the risk rating of business lines and client CDD procedures. Compliance with CDD policies and procedures and the detailed testing of files for CDD documentation are also key elements of the audit function. Finally, examiners should review and evaluate management's responsiveness to criticisms by the audit function.

## Compliance

The responsibility for ensuring effective compliance with relevant laws and regulations may vary among different forms of institutions,

depending on their size, complexity, and availability of resources. Some institutions may have a distinct compliance department with the centralized role of ensuring compliance institution-wide, including private-banking activities. This arrangement is strongly preferable to a situation in which an institution delegates compliance to specific functions, which may result in the management of private-banking operations being responsible for its own internal review. Compliance has a critical role in monitoring private-banking activities; the function should be independent of line management. In addition to ensuring compliance with various laws and regulations such as the Bank Secrecy Act and those promulgated by the Office of Foreign Assets Control, compliance may perform its own internal investigations and due diligence on employees, customers, and third parties with whom the bank has contracted in a consulting or referral capacity and whose behavior, activities, and transactions appear to be unusual or suspicious. Institutions may also find it beneficial for compliance to review and authorize account-opening documentation and CDD adequacy for new accounts. The role of compliance is a control function, but it should not be a substitute for regular and frequent internal audit coverage of the private-banking function. Following is a description of certain regulations that may be monitored by the compliance function.

### *Office of Foreign Assets Control*

The Office of Foreign Assets Control (OFAC) of the U.S. Department of the Treasury administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals. Sanctions are imposed against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction. OFAC acts under presidential wartime and national emergency powers, as well as under authority granted by specific legislation, to impose controls on transactions and freeze foreign assets under U.S. jurisdiction. Many of the sanctions are based on United Nations and other international mandates, are multilateral in scope, and involve close cooperation with allied governments. Under the International Emergency Economic Powers Act, the President can impose sanctions, such as trade embargoes, the

freezing of assets, and import surcharges, on certain foreign countries and the “specially designated nationals” of those countries.

A “specially designated national” is a person or entity who acts on behalf of one of the countries under economic sanction by the United States. Dealing with such nationals is prohibited. Moreover, their assets or accounts in the United States are frozen. In certain cases, the Treasury Department can issue a license to a designated national. This license can then be presented by the customer to the institution, allowing the institution to debit his or her account. The license can be either general or specific.

OFAC screening may be difficult when transactions are conducted through PICs, token names, numbered accounts, or other vehicles that shield true identities. Management must ensure that accounts maintained in a name other than that of the beneficial owner are subject to the same level of filtering for OFAC specially designated nationals and blocked foreign countries as other accounts. That is, the OFAC screening process must include the account’s beneficial ownership as well as the official account name.

Any violation of regulations implementing designated national sanctions subjects the violator to criminal prosecution, including prison sentences and fines to corporations and individuals, per incident. Any funds frozen because of OFAC orders should be placed in a blocked account. Release of those funds cannot occur without a license from the Treasury Department.

### *Bank Secrecy Act*

Guidelines for compliance with the Bank Secrecy Act (BSA) can be found in the FFIEC *BSA/AML Examination Manual*. See also the question-and-answer format interpretations (SR-05-9) of the U.S. Department of Treasury’s regulation (31 CFR 1010) for banking organizations, which is based on section 326 of the Patriot Act. In addition, the procedures for conducting BSA examinations of foreign offices of U.S. banks are detailed in the FFIEC *BSA/AML Examination Manual*. The SAR form filing requirements for nonbank subsidiaries of bank holding companies and state member banks are also set forth in SR-10-8.

## PREPARATION FOR EXAMINATION

The following subsections provide examiners with guidance on preparing for the on-site examination of private-banking operations, including determination of the examination scope and drafting of the first-day-letter questionnaire that is provided to the institution.

### Preexamination Review

To prepare the examiners for their assignments and to determine the appropriate staffing and scope of the examination, the following guidelines should be followed during the preexamination planning process:

- Review the prior report of examination and workpapers for the exam scope; structure and type of private-banking activities conducted; and findings, conclusions, and recommendations of the prior examination. The prior examination report and examination plan should also provide insight to key contacts at the institution and to the time frame of the prior private-banking review.
- Obtain relevant correspondence sent since the prior examination, such as management's response to the report of examination, any applications submitted to the Federal Reserve, and any supervisory action.
- Research press releases and published news stories about the institution and its private-banking activities.
- Review internal and external audit reports and any internal risk assessments performed by the institution on its private-banking activities. Such reports should include an assessment of the internal controls and risk profile of the private-banking function.
- Contact the institution's management to ascertain what changes have occurred since the last exam or are planned in the near future. For example, examiners should determine if there have been changes to the strategic plan; senior management; or the level and type of private-banking activities, products, and services offered. If there is no mention of private banking in the prior examination report, management should be asked at this time if they have commenced or plan to commence any private-banking activities.
- Follow the core examination procedures in the FFIEC *BSA/AML Examination Manual* in order to establish the base scope for the examination of private-banking activities. Review and follow the expanded procedures for private banking and any other expanded procedures that are deemed necessary.

### Examination Staffing and Scope

Once the exam scope has been established and before beginning the new examination, the examiner-in-charge and key administrators of the examination team should meet to discuss the private-banking examination scope, the assignments of the functional areas of private banking, and the supplemental reviews of specific private-banking products and services. If the bank's business lines and services overlap and if its customer base and personnel are shared throughout the organization, examiners may be forced to go beyond a rudimentary review of private-banking operations. They will probably need to focus on the policies, practices, and risks within the different divisions of a particular institution and throughout the institution's global network of affiliated entities.

### Reflection of Organizational Structure

The review of private-banking activities should be conducted on the basis of the financial institution's organizational structure. These structures may vary considerably, depending on the size and sophistication of the institution, its country of origin and the other geographic markets in which it competes, and the objectives and strategies of its management and board of directors. To the extent possible, examiners should understand the level of consolidated private-banking activities an institution conducts in the United States and abroad. This broad view is needed to maintain the "big picture" impact of private banking for a particular institution.

### Risk-Focused Approach

Examiners reviewing the private-banking operations should implement the risk-focused examination approach. The exam scope and



degree of testing of private-banking practices should reflect the degree of risk assumed, prior exam findings on the implementation of policies and procedures, the effectiveness of controls, and an assessment of the adequacy of the internal audit and compliance functions. If initial inquiries into the institution's internal audit and other assessment practices raise doubts about the internal system's effectiveness, expanded analysis and review are required. Examiners should then perform more transaction testing. Examiners will usually need to follow the core examination procedures in the FFIEC *BSA/AML Examination Manual* as well as the expanded procedures for private banking. Other expanded procedures should be followed if circumstances dictate.

### First-Day Letter

As part of the examination preparation, examiners should customize the first-day-letter questionnaire to reflect the structure and type of private-banking activities of the institution and the scope of the exam. The following is a list of requests regarding private banking that examiners should consider including in the first-day letter. Responses to these items should be reviewed in conjunction with responses to the BSA, fiduciary, audit, and internal control inquiries:

- organizational chart for the private bank on both a functional and legal-entity basis
- business or strategic plan
- income and expense statements for the prior fiscal year and current year to date, with projections for the remainder of the current and the next fiscal year, and income by product division and marketing region
- balance-sheet and total assets under management (list the most active and profitable accounts by type, customer domicile, and responsible account officer)
- most recent audits for private-banking activities
- copies of audit committee minutes
- copy of the CDD and SAR form policies and procedures
- list of all new business initiatives introduced last year and this year, relevant new-product-approval documentation that addresses the evaluation of the unique characteristics and risk associated with the new activity or product, and an assessment of the risk-management oversight and control infrastructures in place to manage the risks
- list of all accounts in which an intermediary is acting on behalf of clients of the private bank, for example, as financial advisers or money managers
- explanation of the methodology for following up on outstanding account documentation and a sample report
- description of the method for aggregating client holdings and activities across business units throughout the organization
- explanation of how related accounts, such as common control and family link, are identified
- name of a contact person for information on compensation, training, and recruiting programs for relationship managers
- list of all personal investment company accounts
- list of reports that senior management receives regularly on private-banking activities
- description and sample of the management information reports that monitor account activity
- description of how senior management monitors compliance with global policies for worldwide operations, particularly for offices operating in secrecy jurisdictions
- appropriate additional items from the core and expanded procedures for private banking, as set forth in the FFIEC *BSA/AML Examination Manual*, as well as any other items from the expanded procedures that are needed to gauge the adequacy of the BSA/AML program for private-banking activities.

# Private-Banking Activities

## Examination Objectives

Effective date May 2006

## Section 4128.2

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1. To determine if the policies, practices, procedures, and internal controls regarding private-banking activities are adequate for the risks involved.
2. To determine if the bank's officers and employees are operating in conformance with established guidelines for conducting private-banking activities.
3. To assess the financial condition and income-generation results of the private-banking activities.
4. To determine the scope and adequacy of the audit function for private-banking activities.
5. To determine compliance with applicable laws and regulations for private banking.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations are found.

# Private-Banking Activities

## Examination Procedures

Effective date May 2007

## Section 4128.3

As appropriate, the examiner-in-charge should supplement the following procedures with the examination procedures for private banking set forth in the FFIEC's *BSA/AML Examination Manual*. See that manual's core examination procedures for the BSA/AML compliance program and the expanded examination procedures for private banking.

### PRIVATE-BANKING PREEXAMINATION PROCEDURES

1. As the examiner-in-charge, conduct a meeting with the lead members of the private-banking examination team and discuss—
  - a. the private-banking examination scope (The examination may need to extend beyond a rudimentary review of private-banking operations if the bank's business lines and services overlap and if its customer base and personnel are shared throughout the organization. Examiners will probably need to focus on the policies, practices, and risks within the different divisions of the bank and, if applicable, throughout the bank's domestic or foreign-affiliated entities.);
  - b. examiner assignments for the functional areas of private banking; and
  - c. the supplemental reviews of specific private-banking products and services.
2. Review the prior report of examination and the previous examination's workpapers; description of the examination scope; structure and type of private-banking activities conducted; and findings, conclusions, and recommendations of the prior examination. The prior examination report and examination plan should also provide information and insight on key contacts at the bank and on the time frame of the prior private-banking review.
3. Review relevant correspondence exchanged since the prior examination, such as management's response to the report of examination, any applications submitted to the Federal Reserve, and any supervisory actions.
4. Research press releases and published news stories about the bank and its private-banking activities.

5. Review internal and external audit reports and any internal risk assessments performed by the bank's internal or external auditors on its private-banking activities. Review information on any assessments of the internal controls and risk profile of the private-banking function.
6. Contact management at the bank to ascertain what changes in private-banking services have occurred since the last examination or if there are any planned in the near future.
  - a. Determine if the previous examination or examination report(s) mention private banking; if not, ask management if they have commenced or plan to commence any private-banking activities within any part of the bank's organization.
  - b. Determine if there have been any changes to the strategic plan; senior management; or the level and type of private-banking activities, products, and services offered.
  - c. During the entire examination of private-banking activities, be alert to the totality of the client relationship, product by product, in light of increasing client awareness and use of derivatives, emerging-market products, foreign exchange, and margined accounts.

### FULL-EXAMINATION PHASE

1. After reviewing the private-banking functional areas, draw sound conclusions about the quality and culture of management and stated private-banking policies.
2. Evaluate the adequacy of risk-management policies and practices governing private-banking activities.
3. Assess the organization of the private-banking function and evaluate the quality of management's supervision of private-banking activities. An appraisal of management covers the—
  - a. full range of functions (i.e., supervision and organization, risk management, fiduciary standards, operational controls, management information systems, audit, and compliance) and activities related to

- the operation of the private-banking activities and
- b. discharge of responsibilities by the bank's directors through a long-range organizational plan that accommodates the volume and business services handled, local business practices and the bank's competition, and the growth and development of the bank's private-banking business.
4. Determine if management has effective procedures for conducting ongoing reviews of client-account activity to detect, and protect the client from, any unauthorized activity and any account activity that is inconsistent with the client's profile (for example, frequent or sizable unexplained transfers flowing through the account).
  5. Determine if the bank has initiated private-banking account-opening procedures and documentation requirements that must be satisfied before an account can be opened. Determine if the bank maintains internal controls over these procedures and requirements.
  6. Determine if the bank requires its subsidiary entities and affiliates to maintain and adhere to well-structured customer-due-diligence (CCD) procedures.
  7. Determine if the bank has proper controls and procedures to ensure its proper administration of trust and estates, including strict controls over assets, prudent investment and management of assets, and meticulous recordkeeping. Review previous trust examination reports and consult with the designated Federal Reserve System trust examiners.
  8. Ascertain whether the bank adequately supervises its custody services. The bank should ensure that it, and its nonbank entities, have established and currently maintain procedures for the proper administration of custody services, including the regular review of the services on a preset schedule.
  9. Determine whether the bank's nonbank subsidiaries and affiliates are required to, and actually maintain, strong controls and supervision over funds transfers.
  10. Ascertain if the bank's management and staff are required to perform due diligence, that is, to verify and document that the funds of its private-banking customers were derived through legitimate means, and when extending credit, to verify that the use of loan proceeds was legitimate.
  11. Review the bank's use of deposit accounts.
    - a. Assess the adequacy of the bank's controls and whether they are appropriately used.
    - b. Determine if client monies flow through client deposit accounts and whether the accounts function as the sole conduit and paper trail for client transactions.
  12. Determine and ensure that the bank's approach to Suspicious Activity Reports by Depository Institutions (SAR-DI) forms is proactive and that it has well-established procedures covering the SAR-DI form process. Establish whether there is accountability within the organization for the analysis and follow-up of internally identified suspicious activity (this analysis includes a sound decision on whether the bank needs to file, or is required by regulation to file, a SAR-DI) form.

### INTRODUCTION

The Securities Act of 1933 requires that adequate and reliable information be made available about securities originally offered for sale to the public. The act requires registration of any sale with the Securities and Exchange Commission (SEC) unless it is specifically exempted. Section 4(2) of the act exempts “transactions by an issuer not involving any public offering.” That exemption created a type of business in the securities industry known as “private placements.”

Securities placed privately have certain advantages and disadvantages for both investor and issuer. Through negotiation, both parties may tailor the offering to meet their needs. The issuer saves securities registration costs and obtains alternative financing. The investor makes an investment for a specified length of time at a stated rate of return. Both investor and issuer complete the transaction without being subject to regulatory and public scrutiny.

The major disadvantage of private placements to the investor is the general lack of a secondary market. Thus, the investor may be unable to liquidate the holding until maturity. Additionally, the investor must rely on her or his own expertise when deciding on a purchase. Unlike registered securities, private placements are not reviewed by the SEC. A disadvantage to the issuer is the limitation on the amount of capital that may be raised since the number of investors is usually small. Moreover, advisory fees may be high relative to the size of the issue.

The matching of issuers with investors is usually done by an individual or firm acting as either an agent or an advisor. In the agent relationship, the firm has authority to commit the issuer. An advisor has no such power. Regardless of whether the firm is agent or advisor, it must act prudently and disclose all pertinent information to the investor. Furthermore, the firm must avoid possible conflicts of interest. Agents, usually investment bankers, participate in negotiations between the issuer and investor, and their fee is dependent on their involvement. Agreements between the firm and all other parties should specifically state whom the firm represents as agent.

In 1974, the SEC classified what constitutes an offering exempted from its registration requirements through the issuance of Rule 146.

An offering may be a private placement, under that rule, if the following minimum criteria are met:

- The securities are purchased by no more than 35 persons. A person purchasing at least \$150,000 of an offering need not be counted in the number of purchasers.
- There is no general advertising and no oral or written solicitation of persons other than eligible offerees.
- The securities are offered and sold only to those persons who the issuer believes are (1) sufficiently experienced to evaluate the merits and risks of the investment or (2) able to bear the risk of the investment. Before the sale, purchasers should have the services of an experienced representative.
- Each offeree either has access to or is furnished with the type of information that would be supplied in a registration statement.
- The issuer takes certain specified steps to ensure that the securities are not resold by the purchasers, except according to the rules governing resales.

When all requirements of Rule 146 are met, an offering may still be subject to registration if it is part of a plan to evade SEC registration provisions. The restrictions placed on commercial banks for the private placement of commercial paper are discussed in “Bank Dealer Activities,” section 2030.

### PRIVATE-PLACEMENT ACTIVITIES BY BANKS

A commercial bank’s board of directors assumes additional responsibilities when private-placement services are offered. Private-placement activities, like any other banking function, should be subject to adequate safeguards and policy considerations. When drafting a policy, the board of directors should ensure that self-dealing practices or conflict-of-interest charges cannot develop. Procedures should be developed to monitor private-placement activity whenever such services are provided by the bank or a subsidiary. Moreover, procedures should be in effect to detect any transactions that could have an adverse effect on the bank’s other functions, such as loan or trust department activities.

A bank acting as advisor or agent assumes the risk of a potential conflict-of-interest charge whenever the proceeds from the placement are used to reduce a criticized loan at the bank. Furthermore, the bank must exercise due diligence to disclose relevant information, especially if the issuer is borrowing from the bank and is experiencing financial difficulty. Although the bank may not commit funds in a private-placement transaction, the potential for financial loss or damage to its reputation does exist if

the bank does not prudently deal with all parties to the transaction by disclosing all relevant facts.

The examiner should evaluate the bank's involvement and expertise in private-placement activities by reviewing policies, practices, and procedures. The examiner should also check for compliance with applicable laws and regulations and determine if any significant loss exposure or risk could result from the bank's involvement in private placement.

# Private Placements

## Examination Objectives

Effective date May 1996

## Section 4130.2

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1. To determine if policies, practices, procedures, and internal controls for private placements are adequate and prudent.
2. To determine if bank officers and employees are operating in conformance with established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To evaluate the overall effectiveness and quality of bank management in advising and completing private placements.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient.

# Private Placements Examination Procedures

Effective date March 1984

## Section 4130.3

1. If selected for implementation, complete or update the Private Placements section of the Internal Control Questionnaire.
2. Based upon the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors and determine if corrections have been accomplished.
4. Request the following information from appropriate personnel:
  - a. A list of all private placements advised by the bank since the last examination to include:
    - Name of issuer.
    - Name of investor(s), including banks.
    - Fee and how it was determined.
    - Amount, rate, maturity of issue.
  - b. A list of any funds managed by the bank or its trust department, subsidiaries or affiliates that have been used to purchase private placements advised by the bank or an affiliate.
  - c. A letter from bank counsel regarding legality of the bank's involvement in private placement activities.
  - d. A list of the person(s) performing private placement advisory services and their previous experience.
  - e. A list of investors that the bank normally deals with in placing private offerings and their stated investment requirements.
  - f. A copy of the bank's standard form agreements used in private placement transactions.
  - g. A list of any borrowers whose loans were partially or fully repaid from the sale of private placements advised by the bank since the last examination.
5. Review pertinent information received in performing step 4 and compare it to the list of criticized assets from the previous examination.
6. Forward list of placements to the examiner assigned loan portfolio management and request that he or she determine if any loans were made to fund the investment in the private placement.
7. Review opinions of legal counsel regarding private placements and determine if there are any material deficiencies.
8. Determine if former banking relationships exist for both issuer and investor and determine if fees charged for loans or paid on deposits are within normal bank policy.
9. Review files related to a representative sample of all placement transactions and determine if the bank evaluates both the issuer and investor in a private placement transaction, including the suitability of the investment to the stated investment requirements of the investor.
10. Confer with examiner assigned "Duties and Responsibilities of Directors" and determine if potential conflicts of interest exist between bank-advised placements and interests of directors and principal officers.
11. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
  - a. Deficiencies in policies, practices and internal controls.
  - b. Any hazardous or potentially hazardous placement activities.
  - c. Recommended corrective action.
12. Update the workpapers with any information that will facilitate future examinations.



# Private Placements

## Internal Control Questionnaire

Effective date March 1984

## Section 4130.4

Review the bank's internal controls, policies, practices and procedures for private placement activities. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

### POLICIES

1. Does the bank, bank subsidiary(s) or affiliate(s) provide private placement advisory services?
2. Has the board of directors adopted written policies for private placement activities that:
  - a. Define objectives?
  - b. Provide guidelines for fee determinations based on:
    - Size of transaction?
    - Anticipated degree of difficulty or time involved?
    - Payment of negotiated fees at various stages of the transaction?and not solely on:
    - Deposits on balances or the profitability of the client's other banking relationships?
    - Successful completion of the transaction?
  - c. Require that bank officers act in an advisory rather than agent capacity in all negotiations?  
(An advisor will advise and assist a client, an agent has the authority to commit a client.)
  - d. Recognize possible conflicts of interest and establish appropriate procedures regarding:
    - The purchase of bank-advised private

- placements with funds managed by the bank or an advisory affiliate?
  - Loans to investors to purchase private placements?
  - Use of proceeds of an advised placement to repay the issuer's debts to the bank?
  - Dealings with unsophisticated or non-institutional investors who have other business relationships with the bank?
- e. Require legal review of each placement prior to completion?
  - f. Direct officers to obtain certified financial statements from the seller?
  - g. Require distribution of certified financial statements to interested investors?
  - h. Require officers to request a written statement of investment objectives or requirements from interested investors?
  - i. Provide for a supervisory management review to determine if a placement is suitable for the investor?

### CONCLUSION

3. Is the foregoing information considered adequate as the basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
4. Based on a composite evaluation as evidenced by answers to the foregoing questions, the degree of control by main office management is considered (adequate/inadequate).

### INTRODUCTION

Congress developed a new regulatory framework in 1991 to address the problems associated with troubled depository institutions with the intent of minimizing the long-term cost to the deposit insurance fund. This legislation led to the enactment of the prompt-corrective-action statute, which is contained in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and added section 38 to the Federal Deposit Insurance Act (the FDI Act), as amended (12 USC 1831*o*).

Section 38 requires regulators to administer timely corrective action to banks when their capital position declines or is deemed to have declined below certain threshold levels as a result of an unsafe or unsound condition or practice. The prompt-corrective-action (PCA) framework specifies mandatory actions that regulators must take, as well as discretionary actions they must consider taking.

In order to implement PCA as it applies to state member banks, the Federal Reserve added subpart D to its Regulation H (12 CFR 208.40 to 208.45). The Federal Reserve also revised its Rules of Practice for Hearings (12 CFR 263) to establish procedures for the issuance of notices, directives, and other actions authorized under section 38 of the FDI Act and Regulation H.

PCA utilizes capital ratios to trigger specific actions that are designed to restore a bank to financial health. One of the primary sources of these ratios is the Consolidated Reports of Condition and Income (Call Report), which gives added importance to the review of a bank's records for accuracy during an examination. Under the PCA statute a bank is assigned to one of five capital categories: (1) well capitalized, (2) adequately capitalized, (3) undercapitalized, (4) significantly undercapitalized, and (5) critically undercapitalized. The law provides for increasingly stringent corrective provisions as a bank is placed in progressively lower capital categories.

### PCA CATEGORIES

PCA uses the total risk-based capital, tier 1 risk-based capital, leverage, and tangible equity ratios for assigning state member banks to the

five capital categories.<sup>1</sup> These ratios are defined in the Federal Reserve's Capital Adequacy Guidelines for State Member Banks, appendix A (Risk-Based Measure) and appendix B (Tier 1 Leverage Measure) (12 CFR 208). Determining a bank's PCA category is based upon capital ratios derived from the following: (1) the filing of a quarterly Call Report, (2) receipt of a Federal Reserve or state examination report, (3) information obtained in the application process, or (4) other reports filed by the bank under banking or securities laws.

In general, a bank is deemed to be notified of its PCA category based upon the time of its submission or receipt of—

- the Call Report, as of the date the Call Report is required to be filed,
- the Federal Reserve or state examination report, as of the third day following the date of the transmittal letter accompanying the examination report, and
- other information upon the bank's receipt of written notice by the Board that its capital category has changed.

Notifying a bank of its PCA category is important since any bank falling in the undercapitalized or lower categories is subject to certain mandatory provisions, and may be subject to certain discretionary provisions, immediately upon notification that it is undercapitalized, significantly undercapitalized, or critically undercapitalized. These mandatory and discretionary provisions are described in detail later.

Each PCA category is described below. See the table at the end of this section for a summary of framework definitions. A bank is—

- *well capitalized* if the bank has a total risk-based capital ratio of 10.0 percent or greater, a tier 1 risk-based capital ratio of 6.0 percent or

1. The total risk-based capital ratio is defined as the ratio of qualifying total capital to risk-weighted assets; the tier 1 capital ratio is the ratio of tier 1 capital to risk-weighted assets; and the tier 1 leverage ratio is the ratio of tier 1 capital to total average consolidated assets (the Federal Reserve may use period-end total consolidated total assets whenever necessary, on a case-by-case basis). The tangible equity ratio is defined as core capital elements plus cumulative perpetual preferred stock, net of all intangible assets except those amounts of mortgage servicing assets allowable in tier 1 capital. See section 3020.1 for more detailed information on the capital calculations and requirements.

greater, and a leverage ratio of 5.0 percent or greater, and the bank is not subject to an order, written agreement, capital directive, or prompt-corrective-action directive to meet and maintain a specific capital level for any capital measure.

- *adequately capitalized* if the bank has a total risk-based capital ratio of 8.0 percent or greater, a tier 1 risk-based capital ratio of 4.0 percent or greater, and a leverage ratio of 4.0 percent or greater (or a leverage ratio of 3.0 percent or greater if the bank is rated composite 1 under the CAMELS rating system in its most recent report of examination), and the bank is not experiencing or anticipating significant growth and does not meet the definition of a “well-capitalized” bank.
- *undercapitalized* if the bank has a total risk-based capital ratio that is less than 8.0 percent, a tier 1 risk-based capital ratio that is less than 4.0 percent, or a leverage ratio that is less than 4.0 percent (or a leverage ratio that is less than 3.0 percent if the bank is rated composite 1 under the CAMELS rating system in its most recent report of examination) and the bank is not experiencing or anticipating significant growth.
- *significantly undercapitalized* if the bank has a total risk-based capital ratio that is less than 6.0 percent, a tier 1 risk-based capital ratio that is less than 3.0 percent, or a leverage ratio that is less than 3.0 percent.
- *critically undercapitalized* if the bank has a ratio of tangible equity to total assets that is equal to or less than 2.0 percent.

On July 13, 1998, the Board approved technical amendments to its prompt-corrective-action rules (effective October 1, 1998). The definition of “total assets,” as used in section 208.41(i), was revised to provide the Federal Reserve with the option of using period-end rather than average total assets for state member banks. Another change was to add “Sensitivity to market risk” as the “S” in the CAMEL[S] bank rating system component. See 1998 *Fed. Reg.* 37,634 (volume 63, no. 133).

## EXAMINATION CONSIDERATIONS

If it is determined that a bank is undercapitalized, significantly undercapitalized, or critically undercapitalized, examiners should discuss the

PCA provisions with management during the examination. Additionally, examiners should caution banks when their capital ratios approach those found in the undercapitalized category to ensure that proposed dividend or management fee payments do not cause the bank to violate the statute. Any PCA-related comments should be noted on the “Examination Comments and Conclusions” page of the examination report and in the “Summary to Directors of Examination Findings” report. The comments should be limited to the mandatory provisions of the statute, reflect the immediacy of these provisions, and clearly indicate that the receipt of the report of examination serves as notification that the bank is subject to PCA provisions.

## Capital Adequacy Page

In the report of examination, the PCA capital ratios appear on the “Capital Adequacy” page and are generally calculated using the bank’s most recent Call Report. In situations where the impact of examination findings (for example, loan-loss-reserve adjustments or other losses) cause the bank to fall into a lower PCA category, the narrative portion of this page should explicitly state the adjusted PCA ratios and reconcile the adjustments that were made.

## RECLASSIFICATION

A bank’s PCA category is normally defined by its capital ratios indicated in the preceding definitions. The finding of an unsafe or unsound *condition or practice*, however, may lead to a bank’s reclassification to the next lower category than it would otherwise qualify for based solely on its capital ratios. In these circumstances, the Federal Reserve may—

- reclassify a well-capitalized bank to the adequately capitalized category.
- require an adequately capitalized bank to comply with one or more supervisory actions specified by PCA as though it is an undercapitalized bank.
- impose on an undercapitalized bank one or more supervisory actions authorized for a significantly undercapitalized bank.

While the latter two actions do not strictly represent reclassifications from one category to

another, they are nonetheless collectively referred to as “reclassifications” for PCA purposes.

Thus, section 38 does not automatically subject a bank that has been reclassified to the next lower capital category to the mandatory restrictions of the lower category. These mandatory restrictions can only be imposed through the use of a directive, and only those mandatory and discretionary provisions deemed appropriate by the Federal Reserve will be imposed. *A bank can only be reclassified to the next lower capital category and cannot be classified as critically undercapitalized on any basis other than its tangible equity ratio.*

The reclassification of a bank for PCA purposes may affect the bank’s ability to accept brokered deposits. If a well- or adequately capitalized bank is reclassified, the bank must obtain an FDIC waiver to accept brokered deposits, regardless of its actual capital level. (Section 3000.1 contains a detailed discussion on the capital requirements relating to brokered deposit activities.)

An “unsafe or unsound condition” is not defined in the PCA statute and assessment thereof is left to the discretion of the Federal Reserve. Banks determined to be in an unsafe or unsound condition based on the results of the most recent report of examination or Call Report will be reclassified. On the other hand, an “unsafe or unsound practice” is defined as a less-than-satisfactory rating for any of the AMELS (Asset quality, Management, Earnings, Liquidity or Sensitivity to market risk) components in the bank’s most recent examination report that have not been corrected since the examination. In particular, a bank should be considered for reclassification if the imposition of the available PCA provisions would assist the return of the bank to a safe or sound condition or institute safe or sound practices.

The Federal Reserve recognizes that certain banks that are candidates for reclassification may have taken favorable actions that are consistent with the purposes of PCA. In these cases, reclassification may not be warranted—

- if the bank has raised or can demonstrate current efforts to raise enough capital to become and remain well capitalized for the foreseeable future and
- if the bank has attempted to be in substantial compliance with all provisions of any outstanding informal or formal enforcement action, if management is addressing existing

problems and is considered satisfactory, and if the bank’s condition is stable and shows signs of improvement.

In those instances where reclassification is determined to be appropriate, the Federal Reserve will provide the bank with a written notice specifying its intention to reclassify the bank, along with an explanation of the reasons for the downgrade. The date of the reclassification and the required PCA provisions can be made effective either at a specified future date or, under certain circumstances, immediately, at the discretion of the Federal Reserve. A bank is entitled to an appeal, including an informal hearing, challenging a reclassification following the receipt of a written notice. The appeal and hearing procedures are set out in subpart H of part 263 of the Board’s Rules of Practice for Hearings in section 263.203 (12 CFR 263.203).

## PCA PROVISIONS

### Provisions Applicable to All Banks

While well-capitalized and adequately capitalized banks are generally not subject to any restrictions, they are subject to *two provisions that are applicable to all banks:*

- A bank may not pay dividends or make any other capital distributions that would leave it undercapitalized.<sup>2</sup>
- A bank may not pay a management fee to a controlling person if, after paying the fee, the bank would be undercapitalized. Management fees subject to this restriction include those relating to supervisory, executive, managerial, or policymaking functions, other than compensation to an individual in the individual’s capacity as an officer or employee of the bank. This does not include fees relating to non-managerial services provided by the control-

2. The statute (section 38 (d)(1)(B)) requires that the Federal Reserve consult with the FDIC before approving a capital distribution under this section. Section 38 also contains a limited exception to the restrictions on capital distributions for certain types of stock redemptions that (1) the Federal Reserve has approved, (2) are made in connection with an equivalent issue of additional shares or obligations, and (3) will improve the bank’s financial condition. The Federal Reserve may also impose restrictions on capital distributions on any company that controls a significantly undercapitalized bank.

ling person, such as data processing, trust activities, mortgage services, audit and accounting, property management, or similar services.

### *Restrictions on Advertising*

The Federal Reserve prohibits a bank from advertising its PCA category. A bank may not describe itself in an advertisement or in promotional material as falling within the well-capitalized category, nor may the bank advertise that the Federal Reserve has determined it to be well capitalized. However, a bank is not restricted from advertising its capital levels or financial condition.

### Provisions Applicable to Undercapitalized Banks

A bank categorized as undercapitalized is subject to several *mandatory* provisions that become effective upon notification of the bank. Under the mandatory provisions, an undercapitalized bank—

- must cease paying dividends.
- is prohibited from paying management fees to a controlling person (see the previous subsection for exceptions).
- is subject to increased monitoring by the Federal Reserve and periodic review of the bank's efforts to restore its capital.
- must file and implement a capital restoration plan generally within 45 days. Undercapitalized banks that fail to submit or implement a capital restoration plan are also subject to the provisions applicable to significantly undercapitalized banks.
- may acquire interest in a company, open any new branch offices, or engage in a new line of business only if the following three requirements are met:
  - the Federal Reserve has accepted its capital restoration plan,
  - any increase in total assets is consistent with the capital restoration plan, and
  - the bank's ratio of tangible equity to assets increases during the calendar quarter at a rate sufficient to enable the bank to become adequately capitalized within a reasonable time.
- may not make any acquisition, acquire any

company or depository institution, establish new branches, or engage in any new line of business unless the Federal Reserve determines that such action is consistent with its capital plan or the FDIC determines that such action will further the purposes of PCA.

In addition to the mandatory provisions, a number of *discretionary* provisions may be imposed on an undercapitalized bank. These include—

- requiring one or more of the following:
  - That the bank sell enough additional capital or debt to ensure that it would be adequately capitalized after the sale.
  - That the aforementioned additional capital be voting shares.
  - That the bank accept an offer to be acquired by another institution or company, or that any company that controls the bank be required to divest itself of the bank.
- restricting transactions between the bank and its affiliates.
- restricting the interest rates paid on deposits collected by the bank to the prevailing rates paid on comparable amounts in the region where the bank is located.
- restricting the bank's asset growth or requiring the bank to reduce its total assets.
- requiring the bank or any of its subsidiaries to terminate, reduce, or alter any activity determined by the Federal Reserve to pose excessive risk to the bank.
- ordering a new election of the board of directors, dismissing certain senior executive officers, or hiring new officers.
- prohibiting the acceptance, renewal, and rollover of deposits from correspondent depository institutions.
- prohibiting any bank holding company that controls the bank from making any capital distribution, including but not limited to dividend payment, without the prior approval of the Federal Reserve.
- requiring the bank to divest or liquidate any subsidiary that is in danger of becoming insolvent and that poses a significant risk to the bank, or is likely to cause significant dissipation of its assets or earnings.
- requiring any company that controls the bank to divest or liquidate any affiliate of the bank (other than another insured depository institution) if the Federal Reserve determines that the affiliate is in danger of becoming insolvent

and poses a significant risk to the bank, or is likely to cause significant dissipation of the bank's assets or earnings.

- requiring the bank to take any other action that would more effectively carry out the purpose of PCA than the above actions.

### Provisions Applicable to Significantly Undercapitalized Banks

The mandatory restrictions applicable to undercapitalized banks also apply to banks that are significantly undercapitalized. In addition, a significantly undercapitalized bank is restricted in paying bonuses or raises to senior executive officers of the bank unless it receives prior written approval from the Federal Reserve. If a bank fails to submit an acceptable capital restoration plan, however, no such bonuses or raises may be paid until an acceptable plan has been submitted.

The Federal Reserve, as directed by the PCA statute, must take the following actions unless it is determined that these actions would not further the purpose of PCA:

- Require one or more of the following:
  - That the bank sell enough additional capital or debt to ensure that it would be adequately capitalized after the sale.
  - That the aforementioned additional capital be voting shares.
  - That the bank accept an offer to be acquired by another institution or company, or that any company that controls the bank be required to divest itself of the bank.
- Restrict the bank's transactions with affiliates.
- Restrict the interest rates paid on deposits collected by the bank to the prevailing rates paid on comparable amounts in the region where the bank is located.

In addition to these mandatory provisions, one or more of the discretionary provisions for undercapitalized banks must be imposed on a significantly undercapitalized bank. Moreover, other measures (including the provisions for critically undercapitalized banks) may be required if the Federal Reserve determines that such actions will advance the purposes of PCA.

### Provisions Applicable to Critically Undercapitalized Banks

A critically undercapitalized bank must be placed in conservatorship (with the concurrence of the FDIC) or receivership within 90 days, unless the Federal Reserve and the FDIC concur that other action would better achieve the purposes of PCA. The decision to defer placing a critically undercapitalized bank in conservatorship or receivership must be reviewed every 90 days, and an explanation must be provided about why deferring this decision would better achieve the purposes of the statute (preventing losses to the bank insurance fund).

A bank must be placed in receivership if it continues to be critically undercapitalized on average<sup>3</sup> during the fourth calendar quarter following the period that it initially became critically undercapitalized, unless the Federal Reserve, with the FDIC's concurrence, determines that—

- the bank has a positive net worth.
- the bank has been in substantial compliance with its capital restoration plan since the date of the plan's approval.
- the bank is profitable or has a sustainable upward trend in earnings.
- the bank has reduced its ratio of nonperforming loans to total loans.
- the Chairman of the Federal Reserve and the chairperson of the FDIC both certify that the bank is viable and not expected to fail.

Critically undercapitalized banks are also prohibited, beginning 60 days after becoming critically undercapitalized, from making any payment of principal or interest on subordinated debt issued by the bank without the prior approval of the FDIC. Unpaid interest, however, may continue to accrue on subordinated debt under the terms of the debt instrument. The FDIC is also required, at a minimum, to prohibit a critically undercapitalized bank from doing any of the following without the prior written approval of the FDIC—

- entering into any material transaction not in the usual course of business. Such activities

3. This is determined by adding the sum of the total tangible equity ratio at the close of business on each day during this quarter and dividing that sum by the number of business days in that quarter.



include any investment, expansion, acquisition, sale of assets, or other similar action where the bank would have to notify the Federal Reserve.

- extending credit for any highly leveraged transaction.
- amending the bank's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order.
- making any material change in accounting methods.
- engaging in any covered transaction under section 23A(b) of the Federal Reserve Act.
- paying excessive compensation or bonuses.
- paying interest on new or renewed liabilities that would increase the bank's weighted average cost of funds to a level significantly exceeding the prevailing rates of interest paid on insured deposits in the bank's normal market area.

## Capital Restoration Plans

A bank that is undercapitalized, significantly undercapitalized, or critically undercapitalized must submit a capital restoration plan to the Federal Reserve. The plan should aim to restore the bank's capital to at least the minimum capital levels required for adequately capitalized banks. This plan must be submitted in writing and specify—

- the steps the bank will take to become adequately capitalized.
- the levels of capital the bank expects to attain each year that the plan is in effect.
- how the bank will comply with the restrictions and requirements imposed on it under section 38.
- the types and levels of activities in which the bank will engage.
- any other information required by the Federal Reserve.

A capital restoration plan *cannot be accepted unless* the plan—

- contains the information required in the preceding five points.
- is based on realistic assumptions and is likely to succeed in restoring the bank's capital.
- would not appreciably increase the risk (including credit risk, interest-rate risk, and

other types of risk) to which the bank is exposed.

- contains a guarantee from each company that controls the bank, specifying that the bank will comply with the plan until it has been adequately capitalized on average during each of four consecutive calendar quarters, and each company has provided appropriate assurances of performance. (See the subsequent subsection, Capital Restoration Plan Guarantee, for additional information.)

### *Submission and Review of Capital Plans*

The Federal Reserve has established rules regarding a uniform schedule for the filing and review of capital restoration plans. These rules require a bank to submit a capital restoration plan within 45 days after the bank has received notice, or has been deemed to have been notified, that it is undercapitalized, significantly undercapitalized, or critically undercapitalized. The Federal Reserve may change this period in individual cases, provided it notifies the bank that a different schedule has been adopted. PCA also requires the Federal Reserve to—

- review each capital restoration plan within 60 days of submission of the plan unless it extends the review time.
- provide written notice to the bank about whether it has approved or rejected the capital plan.
- provide a copy of each acceptable capital restoration plan, and amendments thereto, to the FDIC within 45 days of accepting the plan.

There are two cases where a capital restoration plan may not be required:

- When a bank has capital ratios consistent with those corresponding to the adequately capitalized category but, due to unsafe or unsound conditions or practices, has been reclassified to the undercapitalized category. (If the Federal Reserve requires a plan solely due to such a reclassification, the plan should specify the steps the bank will take to correct the unsafe or unsound condition or practice.)
- When a bank's capital category changes, but the bank is already operating under a capital restoration plan accepted by the Federal Reserve.

The Federal Reserve will examine the circumstances of each of the above cases to determine whether a revised plan must be submitted.

### *Capital Restoration Plan Guarantee*

The Federal Reserve cannot approve a capital restoration plan unless each company that controls the bank has guaranteed the bank's compliance with the plan and has provided reasonable assurances of performance. The Federal Reserve will consider on a case-by-case basis the appropriate type of guarantee for multi-tier holding companies, or parent holding companies that are shell companies or that have limited resources. A guarantee that is backed by a contractual pledge of resources from a parent company may satisfy the requirements of section 38, particularly in situations involving the ownership of an insured bank by a foreign holding company through a wholly owned domestic shell holding. In other situations, a third-party guarantee made by a party with adequate financial resources may be satisfactory.

PCA also contains several provisions that clarify the capital restoration plan guarantee:

- **Limitation on liability.** The aggregate amount of liability under the guarantee for all companies that control a specific bank is limited to the lesser of (1) an amount equal to 5 percent of the bank's total assets, or (2) the amount necessary to restore the relevant capital ratios of the bank to the level required for the bank to be categorized as adequately capitalized.
- **Limitation on duration.** The guarantee and limit on liability expires after the Federal Reserve notifies the bank that it has remained adequately capitalized for each of the previous four consecutive calendar quarters.
- **Collection of guarantee.** Each company that controls a given bank is jointly and severally liable for the guarantee.
- **Failure to provide a guarantee.** A bank will be treated as if it had not submitted an acceptable capital restoration plan if its capital plan does not contain the required guarantee.
- **Failure to perform under a guarantee.** A bank will be treated as if it failed to implement the capital restoration plan if any company that controls the bank fails to perform its guarantee.

### *Failure to Submit an Acceptable Capital Plan*

An undercapitalized bank that fails to submit or implement, in any material respect, an acceptable capital restoration plan within the required period is subject to the same provisions applicable to a bank that is significantly undercapitalized. If a bank's capital restoration plan is rejected, the bank is required to submit a new capital plan within the time period specified by the Federal Reserve. During the period following notice of the rejection, and before Federal Reserve approval of a new or revised capital plan, the bank is treated in the same manner as a significantly undercapitalized bank.

## ISSUANCE OF PCA DIRECTIVES

The Federal Reserve must provide a state member bank, or company controlling a state member bank (company), a written notice of proposed action under section 38 (referred to as a directive), unless the circumstances of a particular case indicate that immediate action is necessary to serve the purpose of PCA. These directives are issued for reasons such as reclassifying a bank and implementing discretionary provisions, the latter of which includes the dismissal of directors or senior executive officers.

A notice of intent to issue a directive should include—

- a statement of the bank's capital measures and levels.
- a description of the restrictions, prohibitions, or affirmative actions that the Federal Reserve proposes to impose or require.
- the proposed date when such restrictions or prohibitions would be effective or the proposed date for completion of such affirmative actions.
- the date by which the bank or company subject to the directive may file with the Federal Reserve a written response to the notice.

When a directive becomes effective at a future date, the Federal Reserve must provide the bank or company an opportunity to appeal the directive before taking final action. This requires the bank to submit information relevant to the decision within the time period set by the Federal Reserve, which must be at least 14 cal-



endar days from the date of the notice, unless the Federal Reserve determines that a shorter period is appropriate in light of the financial condition of the bank or other relevant circumstances.

In the case of a directive that is immediately effective upon notification of the bank, the Federal Reserve's rules provide an opportunity for the bank or company to seek an expedited modification or rescission of the directive. A bank or company that appeals a directive effective immediately is required to file a written appeal within 14 days of receiving the notice, and the Board of Governors will consider the appeal within 60 days of receiving it. During the period that the appeal is under review the directive remains in effect, unless the effectiveness of the directive is delayed by the Federal Reserve.

### Dismissal of Directors or Senior Executive Officers

The Federal Reserve's rules establish a special procedure permitting an opportunity for senior executive officers and directors dismissed from a state member bank as a result of a PCA directive to petition for reinstatement. A director or senior executive officer who is required to be

dismissed in compliance with a Federal Reserve directive may have the dismissal reviewed by filing, within 10 days, a petition for reinstatement with the Federal Reserve. The petitioner will also be given the opportunity to submit written materials in support of the petition and to appear at an informal hearing before representatives of the Federal Reserve. The date for the hearing and for the ultimate decision follows the same timeframe as that indicated for the appeals process in the preceding paragraph.

### Enforcement of Directives

PCA directives may be enforced in the federal courts, and may cause any bank, company, or bank-affiliated party that violates the directive to be subject to civil money penalties or other enforcement actions. The failure of a bank to implement a capital restoration plan, or the failure of a company having control of a state member bank to fulfill a guarantee that the company has given in connection with a capital plan accepted by the Federal Reserve, could subject the bank or company or any of their bank-affiliated parties to a civil money penalty assessment.

**TABLE—SUMMARY OF SPECIFICATIONS OF CAPITAL CATEGORIES FOR PROMPT CORRECTIVE ACTION**

<i>Capital category</i>	<i>Total risk-based ratio</i>	<i>Tier 1 risk-based ratio</i>	<i>Leverage ratio</i>	<i>Additional criteria</i>
Well capitalized	10% or above; plus	6% or above; plus	5% or above; plus	is not subject to a capital directive to meet a specific level for any capital measure
Adequately capitalized	8% or above; plus	4% or above; plus	4% or above; <sup>1</sup> plus	does not meet the definition of well capitalized
Under-capitalized	under 8%; or	under 4%; or	under 4% <sup>2</sup>	
Significantly under-capitalized	under 6%; or	under 3%; or	under 3%	
Critically under-capitalized	not applicable	not applicable	not applicable	can only be assigned to this category if the ratio of tangible equity to total assets is equal to or less than 2% <sup>3</sup>

1. Three percent or above for banks rated composite 1 in their most recent report of examination and that are not experiencing or anticipating significant growth.

2. Under 3 percent for banks rated composite 1 in their most recent report of examination and that are not experiencing or anticipating significant growth.

3. Tangible equity is defined as core capital elements plus cumulative perpetual preferred stock, net of all intangible assets except those amounts of mortgage-servicing assets allowable into tier 1 capital.

# Prompt Corrective Action

## Examination Objectives

Effective date November 1994

## Section 4133.2

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1. To determine if prompt-corrective-action (PCA) provisions are necessary.
2. To determine if the policies, practices, and procedures are in place to ensure compliance with PCA mandatory and discretionary provisions.
3. To ensure that undercapitalized, significantly undercapitalized, and critically undercapitalized banks have effective capital restoration plans that comply with PCA.

# Prompt Corrective Action

## Examination Procedures

Effective date November 2006

## Section 4133.3

1. During on-site examinations, validate the state member bank's capital levels, risk-weighted assets, and capital ratios in compliance with primary capital provisions of section 38 of the Federal Deposit Insurance Act (FDI Act) and the Federal Reserve's respective capital adequacy rules. (See section 3020.1 and 12 CFR 208, appendices A, B, and E.) Verify that the bank's—
  - a. capital instruments are appropriate for inclusion in tier 1 or tier 2 capital.
  - b. assets were properly risk weighted and that the appropriate credit equivalent measure (for example, the credit-conversion factors, credit-rating factors, etc.) were assigned for the bank's off-balance-sheet assets or transactions.
2. When a state member bank is considered undercapitalized, significantly undercapitalized, or critically undercapitalized, discuss with the bank's management the prompt corrective action restrictions under Section 38 of the FDI Act and the Board's Regulation H (12 CFR 208, subpart D)
3. When a state member bank is operating with an amount of consolidated capital that is near the undercapitalized levels, caution the board of directors and senior management about their ensuring that any proposed dividend or management fee payments do not cause the bank to violate section 38 of the FDI Act.
4. When the impact of the bank's examination findings (for example, loan-loss-reserve adjustments or other losses) will cause the bank to fall into a lower prompt-corrective-action category, explicitly state in the narrative portion of the Capital examination report page the adjusted prompt-corrective-action capital ratios with a clear account of the adjustments that were made to the quarter-end or period-end ratios.
5. Include in the "Comments and Conclusions" report page of the state member bank examination report and the Director's Summary any comments regarding the applicability of section 38 and Regulation H pertaining to prompt corrective action. With regard to prompt corrective action, limit the comments to the mandatory restrictions of the statute and the immediacy of those provisions. State that the receipt of the state member bank examination report serves as notification that the bank is subject to prompt corrective action.

The Board's long-standing policy on real estate appraisals emphasizes the importance of sound appraisal policies and collateral-valuation procedures in a bank's real estate lending activity. With the passage of title XI (12 USC 3331) of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Board as well as the other federal financial regulatory agencies adopted regulations in August 1990 on the performance and use of appraisals by federally regulated financial institutions, which were subsequently amended in June 1994. The Board's appraisal standards regulation may be found in Regulation H, subpart E, 12 CFR 208.50–51.<sup>1</sup>

The Board's appraisal regulation requires, at a minimum, that real estate appraisals be performed in accordance with generally accepted uniform appraisal standards as evidenced by the appraisal standards promulgated by the Appraisal Standards Board (ASB), and that such appraisals be in writing.<sup>2</sup> The regulation also sets forth additional appraisal standards including that the appraisal and analysis contain sufficient information to support the bank's decision to engage in the transaction and provide the real property's market value.

The intent of title XI and the Board's regulation is to protect federal financial and public policy interests in real estate-related financial transactions that require the services of an appraiser in connection with federally related transactions.<sup>3</sup> Federally related transactions are defined as those real estate-related financial transactions that an agency engages in, contracts for, or regulates and that require the services of an appraiser.<sup>4</sup> Each state has established a program for certifying and licensing real estate appraisers who are qualified to perform apprais-

als in connection with federally related transactions. Additionally, title XI designated the Appraisal Qualifications Board and the ASB of the Appraisal Foundation, a nonprofit appraisal industry group, as the authority for establishing qualifications criteria for appraiser certification and standards for the performance of an appraisal. The statute established the Appraisal Subcommittee of the Federal Financial Institutions Examination Council (FFIEC). It was designated the entity to monitor the requirements established to meet the intent of title XI. If the Appraisal Subcommittee issues a finding that the policies, practices, or procedures of a state are inconsistent with title XI, the services of licensed or certified appraisers from that state may not be used in connection with federally related transactions. Further, several provisions in title XI of FIRREA were amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), providing additional authority to the Appraisal Subcommittee in its oversight of states' appraiser regulatory programs. (See sections 1471-1473 of Pub. L. 111-203, 124 Stat. 1376 (2010).)

Over the years, the Board and the other federal banking regulatory agencies (the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (the agencies)) have issued several appraisal-related guidance documents to assist institutions in implementing and complying with the appraisal regulation.<sup>5</sup> In December 2010, the agencies issued the Interagency Appraisal and Evaluation Guidelines (Interagency Guidelines) to clarify their appraisal regulations and to promote best practices in institutions' appraisal and evaluation programs. (See SR-10-16.) The Interagency Guidelines pertain to all real estate-related financial transactions originated or purchased by a regulated institution or its operating subsidiary for its own portfolio or as assets held for sale, including activities of commercial and residential real estate mortgage operations, capital markets groups, and asset securitization and sales units. The Interagency Guidelines provide a comprehensive discussion of the Board's expectations for a bank's appraisal and evaluation

1. A bank is required to use a certified appraiser for—
  - all federally related transactions over \$1 million,
  - nonresidential federally related transactions more than \$250,000, and
  - complex residential federally related transactions more than \$250,000.

A bank is requested to use either a state-certified or a state-licensed appraiser for noncomplex residential federally related transactions that are under \$1 million. A complex one- to four-family residential property appraisal means that the properties to be appraised, the form of ownership, or market conditions are atypical.

2. See 12 USC 3339.
3. See 12 USC 3339.
4. See 12 USC 3350(4).

5. The Board has issued several other guidance documents related to appraisals and real estate lending that provide additional information on the establishment of an effective real estate appraisal and evaluation program. (See SR-95-16, SR-95-27, SR-05-05, SR-05-11, and SR-05-14.)

program as well as background information on the technical aspects of appraisals.

A bank's collateral-valuation program needs to consider when an appraisal or evaluation should be obtained to monitor collateral risk and to support credit analysis, including for purposes of rating or classifying the credit. When a credit becomes troubled, the primary source of repayment often shifts from the borrower's cash flow and income to the expected proceeds from the sale of the real estate collateral. Therefore, it is important that banks have a sound and independent basis for determining the value of the real estate collateral. (See SR-09-07.)

The expectations that an institution conduct its appraisal and evaluation program for real estate lending in a safe and sound manner remains unchanged with the issuance of the Interagency Guidelines. They reflect developments concerning appraisals and evaluations, as well as changes in appraisal standards and advancements in regulated institutions' collateral valuation methods. The Interagency Guidelines also promote consistency in the application and enforcement of the agencies' appraisal regulations. (See SR-10-16.)

## INTERAGENCY APPRAISAL AND EVALUATION GUIDELINES (INTERAGENCY GUIDELINES)

FIRREA requires each agency to prescribe appropriate standards for the performance of real estate appraisals in connection with "federally related transactions,"<sup>6</sup> which are defined as those real estate-related financial transactions that an agency engages in, contracts for, or regulates and that require the services of an appraiser.<sup>7</sup> The agencies' appraisal regulations must require, at a minimum, that real estate appraisals be performed in accordance with generally accepted uniform appraisal standards as evidenced by the appraisal standards promulgated by the ASB, and that such appraisals be in writing.<sup>8</sup> An agency may require compliance with additional appraisal standards if it makes a determination that such additional standards are required to properly carry out its statutory responsibilities.<sup>9</sup> Each of the

agencies has adopted additional appraisal standards.<sup>10</sup>

The agencies' real estate lending regulations and guidelines,<sup>11</sup> issued pursuant to section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA),<sup>12</sup> require each institution to adopt and maintain written real estate lending policies that are consistent with principles of safety and soundness and that reflect consideration of the real estate lending guidelines issued as an appendix to the regulations. The real estate lending guidelines state that an institution's real estate lending program should include an appropriate real estate appraisal and evaluation program.

## SUPERVISORY POLICY

An institution's real estate appraisal and evaluation policies and procedures will be reviewed as part of the examination of the institution's overall real estate-related activities. Examiners will consider the size and the nature of an institution's real estate-related activities when assessing the appropriateness of its program.

While borrowers' ability to repay their real estate loans according to reasonable terms remains the primary consideration in the lending decision, an institution also must consider the value of the underlying real estate collateral in accordance with the Board's appraisal regulations. Institutions that fail to comply with the Board's appraisal regulations or to maintain a sound appraisal and evaluation program consistent with supervisory guidance will be cited in supervisory letters or examination reports and may be criticized for unsafe and unsound banking practices. Deficiencies will require appropriate corrective action.

When analyzing individual transactions, examiners will review an appraisal or evaluation to determine whether the methods, assumptions, and value conclusions are reasonable. Examiners also will determine whether the appraisal or evaluation complies with the Board's appraisal regulations and is consistent with supervisory guidance as well as the institution's policies. Examiners will review the steps taken by an

10. See, e.g., 12 CFR 208, subpart E, and 12 CFR 225, subpart G.

11. See 12 CFR 208, subpart E.

12. See Pub. L. 102-242, section 304, 105 Stat. 2354 (1991); 12 USC 1828(o).

6. See 12 USC 3339.

7. See 12 USC 3350(4).

8. See 12 USC 3339.

9. See 12 USC 3339.

institution to ensure that the persons who perform the institution's appraisals and evaluations are qualified, competent, and are not subject to conflicts of interest.

## APPRAISAL AND EVALUATION PROGRAM

An institution's board of directors or its designated committee is responsible for adopting and reviewing policies and procedures that establish an effective real estate appraisal and evaluation program. The program should

- provide for the independence of the persons ordering, performing, and reviewing appraisals or evaluations;
- establish selection criteria and procedures to evaluate and monitor the ongoing performance of appraisers and persons who perform evaluations;
- ensure that appraisals comply with the Board's appraisal regulations and are consistent with supervisory guidance;
- ensure that appraisals and evaluations contain sufficient information to support the credit decision;
- maintain criteria for the content and appropriate use of evaluations consistent with safe and sound banking practices;
- provide for the receipt and review of the appraisal or evaluation report in a timely manner to facilitate the credit decision;
- develop criteria to assess whether an existing appraisal or evaluation may be used to support a subsequent transaction;
- implement internal controls that promote compliance with these program standards, including those related to monitoring third-party arrangements;
- establish criteria for monitoring collateral values; and
- establish criteria for obtaining appraisals or evaluations for transactions that are not otherwise covered by the appraisal requirements of the Board's appraisal regulations.

## INDEPENDENCE OF THE APPRAISAL AND EVALUATION PROGRAM

For both appraisal and evaluation functions, an

institution should maintain standards of independence as part of an effective collateral-valuation program for all of its real estate lending activity. The collateral-valuation program is an integral component of the credit underwriting process and, therefore, should be isolated from influence by the institution's loan-production staff. An institution should establish reporting lines independent of loan production for staff who administer the institution's collateral-valuation program, including the ordering, reviewing, and acceptance of appraisals and evaluations. Appraisers must be independent of the loan production and collection processes and have no direct, indirect, or prospective interest, financial or otherwise, in the property or transaction.<sup>13</sup> These standards of independence also should apply to persons who perform evaluations.

For a small or rural institution or branch, it may not always be possible or practical to separate the collateral-valuation program from the loan-production process. If absolute lines of independence cannot be achieved, an institution should be able to demonstrate clearly that it has prudent safeguards to isolate its collateral-valuation program from influence or interference from the loan-production process. In such cases, another loan officer, official, or director of the institution may be the only person qualified to analyze the real estate collateral. To ensure their independence, such lending officials, officers, or directors must abstain from any vote or approval involving loans on which they ordered, performed, or reviewed the appraisal or evaluation.

Communication between the institution's collateral-valuation staff and an appraiser or person performing an evaluation is essential for the exchange of appropriate information relative to the valuation assignment. An institution's policies and procedures should specify methods for communication that ensure independence in the collateral-valuation function. These policies and procedures should foster timely and appropriate communications regarding the assignment and establish a process for responding to questions from the appraiser or person performing an evaluation.

13. The Board's appraisal regulations set forth specific appraiser independence requirements that exceed those set forth in the Uniform Standards of Professional Appraisal Practice. Institutions also should be aware of separate requirements on conflicts of interest under Regulation Z (Truth in Lending), 12 CFR 226.42(d).

An institution may exchange information with appraisers and persons who perform evaluations, which may include providing a copy of the sales contract<sup>14</sup> for a purchase transaction. However, an institution should not directly or indirectly coerce, influence, or otherwise encourage an appraiser or a person who performs an evaluation to misstate or misrepresent the value of the property.<sup>15</sup> Consistent with its policies and procedures, an institution also may request the appraiser or person who performs an evaluation to

- consider additional information about the subject property or about comparable properties;
- provide additional supporting information about the basis for a valuation; or
- correct factual errors in an appraisal.

An institution's policies and procedures should ensure that it avoids inappropriate actions that would compromise the independence of the collateral-valuation function,<sup>16</sup> including

- communicating a predetermined, expected, or qualifying estimate of value, or a loan amount or target loan-to-value ratio to an appraiser or person performing an evaluation;
- specifying a minimum value requirement for the property that is needed to approve the loan or as a condition of ordering the valuation;
- conditioning a person's compensation on loan consummation;
- failing to compensate a person because a property is not valued at a certain amount;<sup>17</sup>
- implying that current or future retention of a person's services depends on the amount at which the appraiser or person performing an evaluation values a property; or
- excluding a person from consideration for future engagement because a property's

reported market value does not meet a specified threshold.

After obtaining an appraisal or evaluation, or as part of its business practice, an institution may find it necessary to obtain another appraisal or evaluation of a property and it would be expected to adhere to a policy of selecting the most credible appraisal or evaluation, rather than the appraisal or evaluation that states the highest value. (Refer to the "Reviewing Appraisals and Evaluations" subsection below for additional information on determining and documenting the credibility of an appraisal or evaluation.) Further, an institution's reporting of a person suspected of noncompliance with the Uniform Standards of Professional Appraisal Practice (USPAP), and applicable federal or state laws or regulations, or otherwise engaged in other unethical or unprofessional conduct to the appropriate authorities would not be viewed by the Federal Reserve as coercion or undue influence. However, an institution should not use the threat of reporting a false allegation in order to influence or coerce an appraiser or a person who performs an evaluation.

## SELECTION OF APPRAISERS OR PERSONS WHO PERFORM EVALUATIONS

An institution's collateral-valuation program should establish criteria to select, evaluate, and monitor the performance of appraisers and persons who perform evaluations. The criteria should ensure that

- The person selected possesses the requisite education, expertise, and experience to competently complete the assignment.
- The work performed by appraisers and persons providing evaluation services is periodically reviewed by the institution.
- The person selected is capable of rendering an unbiased opinion.
- The person selected is independent and has no direct, indirect, or prospective interest, financial or otherwise, in the property or transaction.
- The appraiser selected to perform an appraisal holds the appropriate state certification or license at the time of the assignment. Persons who perform evaluations should possess the

14. Refer to USPAP Standards Rule 1-5(a) and the Ethics Rule.

15. For mortgage transactions secured by a consumer's principal dwelling, refer to 12 CFR 226.42 under Regulation Z (Truth in Lending). Regulation Z also prohibits a creditor from extending credit when it knows that the appraiser independence standards have been violated, unless the creditor determines that the value of the property is not materially misstated.

16. See 12 CFR 226.42(c).

17. This provision does not preclude an institution from withholding compensation from an appraiser or person who provided an evaluation based on a breach of contract or substandard performance of services under a contractual provision.



appropriate appraisal or collateral-valuation education, expertise, and experience relevant to the type of property being valued. Such persons may include appraisers, real estate lending professionals, agricultural extension agents, or foresters.<sup>18</sup>

An institution or its agent must directly select and engage appraisers. The only exception to this requirement is that the agencies' appraisal regulations allow an institution to use an appraisal prepared for another financial services institution provided certain conditions are met. An institution or its agents also should directly select and engage persons who perform evaluations. Independence is compromised when a borrower recommends an appraiser or a person to perform an evaluation. Independence is also compromised when loan-production staff selects a person to perform an appraisal or evaluation for a specific transaction. For certain transactions, an institution also must comply with the provisions addressing valuation independence in Regulation Z (Truth in Lending).<sup>19</sup>

An institution's selection process should ensure that a qualified, competent, and independent person is selected to perform a valuation assignment. An institution should maintain documentation to demonstrate that the appraiser or person performing an evaluation is competent, independent, and has the relevant experience and knowledge for the market, location, and type of real property being valued. Further, the person who selects or oversees the selection of appraisers or persons providing evaluation services should be independent from the loan production area. An institution's use of a borrower-ordered or borrower-provided appraisal violates the agencies' appraisal regulations. However, a borrower can inform an institution that a current appraisal exists, and the institution may request it directly from the other financial services institution.

## Approved Appraiser List

If an institution establishes an approved appraiser

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18. Although not required, an institution may use state-certified or state-licensed appraisers to perform evaluations. Institutions should refer to USPAP Advisory Opinion 13 for guidance on appraisers performing evaluations of real property collateral.

19. See 12 CFR 226.42.

list for selecting an appraiser for a particular assignment, the institution should have appropriate procedures for the development and administration of the list. These procedures should include a process for qualifying an appraiser for initial placement on the list, as well as periodic monitoring of the appraiser's performance and credentials to assess whether to retain the appraiser on the list. Further, there should be periodic internal review of the use of the approved appraiser list to confirm that appropriate procedures and controls exist to ensure independence in the development, administration, and maintenance of the list. For residential transactions, loan-production staff can use a revolving, preapproved appraiser list, provided the development and maintenance of the list is not under their control.

## Engagement Letters

An institution should use written engagement letters when ordering appraisals, particularly for large, complex, or out-of-area commercial real estate properties. An engagement letter facilitates communication with the appraiser and documents the expectations of each party to the appraisal assignment. In addition to the other information, the engagement letter will identify the intended use and user(s), as defined in USPAP. An engagement letter also may specify whether there are any legal or contractual restrictions on the sharing of the appraisal with other parties. An institution should include the engagement letter in its credit file. To avoid the appearance of any conflict of interest, appraisal or evaluation development work should not commence until the institution has selected and engaged a person for the assignment.

## TRANSACTIONS THAT REQUIRE APPRAISALS

Although the agencies' appraisal regulations exempt certain real estate-related financial transactions from the appraisal requirement, most real estate-related financial transactions over the appraisal threshold are considered federally related transactions and, thus, require appraisals.<sup>20</sup> The agencies also reserve the right to

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20. In order to facilitate recovery in designated major disaster areas, subject to safety and soundness considerations,

require an appraisal under their appraisal regulations to address safety and soundness concerns in a transaction. (See “Appendix A—Appraisal Exemptions.”)

## MINIMUM APPRAISAL STANDARDS

The Board’s appraisal regulations include minimum standards for the preparation of an appraisal. (See “Appendix D—Glossary” for terminology used in these guidelines.) The appraisal must

- *Conform to generally accepted appraisal standards as evidenced by the USPAP promulgated by the ASB of the Appraisal Foundation unless principles of safe and sound banking require compliance with stricter standards.* Although allowed by USPAP, the agencies’ appraisal regulations do not permit an appraiser to appraise any property in which the appraiser has an interest, direct or indirect, financial or otherwise in the property or transaction. Further, the appraisal must contain an opinion of market value as defined in the agencies’ appraisal regulations. (See discussion on the definition of market value below.) Under USPAP, the appraisal must contain a certification that the appraiser has complied with USPAP. An institution may refer to the appraiser’s USPAP certification in its assessment of the appraiser’s independence concerning the transaction and the property. Under the agencies’ appraisal regulations, the result of an Automated Valuation Model (AVM), by itself or signed by an appraiser, is not an appraisal, because a state-certified or state-licensed appraiser must perform an appraisal in conformance with USPAP and the agencies’ minimum appraisal standards. Further, the Dodd-Frank Act<sup>21</sup> provides “[i]n conjunction with the purchase of a consumer’s principal dwelling, broker price opinions may not be used as the primary basis to determine the value of a piece of property for the purpose of loan origination of a residential mortgage loan

secured by such piece of property.”<sup>22</sup>

- *Be written and contain sufficient information and analysis to support the institution’s decision to engage in the transaction.* An institution should obtain an appraisal that is appropriate for the particular federally related transaction, considering the risk and complexity of the transaction. The level of detail should be sufficient for the institution to understand the appraiser’s analysis and opinion of the property’s market value. As provided by the USPAP Scope of Work Rule, appraisers are responsible for establishing the scope of work to be performed in rendering an opinion of the property’s market value. An institution should ensure that the scope of work is appropriate for the assignment. The appraiser’s scope of work should be consistent with the extent of the research and analyses employed for similar property types, market conditions, and transactions. Therefore, an institution should be cautious in limiting the scope of the appraiser’s inspection, research, or other information used to determine the property’s condition and relevant market factors, which could affect the credibility of the appraisal.

According to USPAP, appraisal reports must contain sufficient information to enable the intended user of the appraisal to understand the report properly. An institution should specify the use of an appraisal report option that is commensurate with the risk and complexity of the transaction. The appraisal report should contain sufficient disclosure of the nature and extent of inspection and research performed by the appraiser to verify the property’s condition and support the appraiser’s opinion of market value. (See “Appendix D—Glossary” for the definition of appraisal report options.)

Institutions should be aware that provisions in the Dodd-Frank Act address appraisal requirements for a *higher-risk mortgage* to a consumer.<sup>23</sup> To implement these provisions, the agencies recognize that future regulations will address the requirement that the appraiser conduct a physical property visit of the interior of the mortgaged property.<sup>24</sup>

the Depository Institutions Disaster Relief Act of 1992 provides the Board with the authority to waive certain appraisal requirements for up to three years after a presidential declaration of a natural disaster. Pub. L. 102-485, section 2, 106 Stat. 2771 (October 23, 1992); 12 USC 3352.

21. Pub. L. 111-203, 124 Stat. 1376 (2010).

22. Dodd-Frank Act, section 1473(r).

23. Under the law, the provisions are effective 12 months after final regulations to implement the provisions are published. See Dodd-Frank Act, section 1400(c)(1) or 12 USC 1601.

24. Section 1471 of the Dodd-Frank Act added new section

- *Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units.* Appraisers must analyze, apply, and report appropriate deductions and discounts when providing an estimate of market value based on demand for real estate in the future. This standard is designed to avoid having appraisals prepared using unrealistic assumptions and inappropriate methods in arriving at the property's market value. (See "Appendix C—Deductions and Discounts" for further explanation on deductions and discounts.)
- *Be based upon the definition of market value set forth in the appraisal regulation.* Each appraisal must contain an estimate of market value, as defined by the agencies' appraisal regulations. The definition of market value assumes that the price is not affected by undue stimulus, which would allow the value of the real property to be increased by favorable financing or seller concessions. Value opinions such as "going concern value," "value in use," or a special value to a specific property user may not be used as market value for federally related transactions. An appraisal may contain separate opinions of such values so long as they are clearly identified and disclosed.

The estimate of market value should consider the real property's actual physical condition, use, and zoning as of the effective date of the appraiser's opinion of value. For a transaction financing construction or renovation of a building, an institution would generally request an appraiser to provide the property's current market value in its "as is" condition, and, as applicable, its prospective market value upon completion and/or prospective market value upon stabilization. Prospective market value opinions should be based upon current and reasonably expected market conditions. When an appraisal includes prospective market value opinions, there should be a point of reference to the market conditions and time frame on which the appraiser based the analysis.<sup>25</sup> An institution should understand the real property's "as is" market value and should consider the prospective

market value that corresponds to the credit decision and the phase of the project being funded, if applicable.

- *Be performed by state-certified or state-licensed appraisers in accordance with requirements set forth in the appraisal regulation.* In determining competency for a given appraisal assignment, an institution must consider an appraiser's education and experience. While an institution must confirm that the appraiser holds a valid credential from the appropriate state appraiser regulatory authority, a state certification or license is a minimum credentialing requirement. Appraisers are expected to be selected for individual assignments based on their competency to perform the appraisal, including knowledge of the property type and specific property market.

As stated in the agencies' appraisal regulations, a state-certified or state-licensed appraiser may not be considered competent solely by virtue of being certified or licensed. In communicating an appraisal assignment, an institution should convey to the appraiser that the agencies' minimum appraisal standards must be followed.

## APPRAISAL DEVELOPMENT

The Board's appraisal regulations require appraisals for federally related transactions to comply with the requirements in USPAP, some of which are addressed below. Consistent with the USPAP Scope of Work Rule,<sup>26</sup> the appraisal must reflect an appropriate scope of work that provides for "credible" assignment results. The appraiser's scope of work should reflect the extent to which the property is identified and inspected, the type and extent of data researched, and the analyses applied to arrive at opinions or conclusions. Further, USPAP requires the appraiser to disclose whether he or she previously appraised the property.

While an appraiser must comply with USPAP and establish the scope of work in an appraisal assignment, an institution is responsible for obtaining an appraisal that contains sufficient information and analysis to support its decision to engage in the transaction. Therefore, to ensure that an appraisal is appropriate for the intended use, an institution should discuss its

<sup>129H</sup> to the Truth in Lending Act (15 USC 1631 et seq.).

<sup>25</sup>. See USPAP, Statement 4 on Prospective Value Opinions, for further explanation.

<sup>26</sup>. See USPAP, Scope of Work Rule, Advisory Opinions 28 and 29.

needs and expectations for the appraisal with the appraiser. Such discussions should assist the appraiser in establishing the scope of work and form the basis of the institution's engagement letter, as appropriate. These communications should adhere to the institution's policies and procedures on independence of the appraiser and not unduly influence the appraiser. An institution should not allow lower cost or the speed of delivery time to inappropriately influence its appraisal ordering procedures or the appraiser's determination of the scope of work for an appraisal supporting a federally related transaction.

As required by USPAP, the appraisal must include any approach to value (that is, the cost, income, and sales comparison approaches) that is applicable and necessary to the assignment. Further, the appraiser should disclose the rationale for the omission of a valuation approach. The appraiser must analyze and reconcile the information from the approaches to arrive at the estimated market value. The appraisal also should include a discussion on market conditions, including relevant information on property value trends, demand and supply factors, and exposure time. Other information might include the prevalence and effect of sales and financing concessions, the list-to-sale price ratio, and availability of financing. In addition, an appraisal should reflect an analysis of the property's sales history and an opinion as to the highest and best use of the property. USPAP requires the appraiser to disclose whether or not the subject property was inspected and whether anyone provided significant assistance to the appraiser signing the appraisal report.

## APPRAISAL REPORTS

An institution is responsible for identifying the appropriate appraisal report option to support its credit decisions. The institution should consider the risk, size, and complexity of the transaction and the real estate collateral when determining the appraisal report format to be specified in its appraisal engagement instructions to an appraiser.

USPAP provides various appraisal report options that an appraiser may use to present the results of appraisal assignments. The major difference among these report options is the

level of detail presented in the report. A report option that merely states, rather than summarizes or describes the content and information required in an appraisal report, may lack sufficient supporting information and analysis to explain the appraiser's opinions and conclusions.

Generally, a report option that is restricted to a single client and intended user will not be appropriate to support most federally related transactions. These reports lack sufficient supporting information and analysis for underwriting purposes. These less detailed reports may be appropriate for real estate portfolio monitoring purposes. (See "Appendix D—Glossary" for the definition of appraisal report options.)

Regardless of the report option, the appraisal report should contain sufficient detail to allow the institution to understand the scope of work performed. Sufficient information should include the disclosure of research and analysis performed, as well as disclosure of the research and analysis typically warranted for the type of appraisal, but omitted, along with the rationale for its omission.

## TRANSACTIONS THAT REQUIRE EVALUATIONS

The Board's appraisal regulations permit an institution to obtain an appropriate evaluation of real property collateral in lieu of an appraisal for transactions that qualify for certain exemptions. These exemptions include transactions that—

- Have a transaction value equal to or less than the appraisal threshold of \$250,000.
- Constitute a business loan with a transaction value equal to or less than the business loan threshold of \$1 million, and is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment.
- Involve an existing extension of credit at the lending institution, provided that
  - There has been no obvious and material change in market conditions or physical aspects of the property that threaten the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or
  - There is no advancement of new monies other than funds necessary to cover reasonable closing costs.

For more information on real estate–related financial transactions that are exempt from the appraisal requirement, see “Appendix A—Appraisal Exemptions.” For a discussion on changes in market conditions, see the “Validity of Appraisals and Evaluations” subsection below.

Although the Board’s appraisal regulations allow an institution to use an evaluation for certain transactions, an institution should establish policies and procedures for determining when to obtain an appraisal for such transactions. For example, an institution should consider obtaining an appraisal as an institution’s portfolio risk increases or for higher risk real estate–related financial transactions, such as those involving

- loans with combined loan-to-value ratios in excess of the supervisory loan-to-value limits,
- atypical properties,
- properties outside the institution’s traditional lending market,
- transactions involving existing extensions of credit with significant risk to the institution, or
- borrowers with high-risk characteristics.

## EVALUATION DEVELOPMENT

An evaluation must be consistent with safe and sound banking practices and should support the institution’s decision to engage in the transaction. An institution should be able to demonstrate that an evaluation, whether prepared by an individual or supported by an analytical method or a technological tool, provides a reliable estimate of the collateral’s market value as of a stated effective date prior to the decision to enter into a transaction. (Refer to Appendix B—Evaluations Based on Analytical Methods or Technological Tools.)

A valuation method that does not provide a property’s market value or sufficient information and analysis to support the value conclusion is not acceptable as an evaluation. For example, a valuation method that provides a sales or list price, such as a broker price opinion, cannot be used as an evaluation because, among other things, it does not provide a property’s market value. Further, the Dodd-Frank Act provides “[i]n conjunction with the purchase of a consumer’s principal dwelling, broker price opinions may not be used as the primary basis to

determine the value of a piece of property for the purpose of loan origination of a residential mortgage loan secured by such piece of property.”<sup>27</sup> Likewise, information on local housing conditions and trends, such as a competitive market analysis, does not contain sufficient information on a specific property that is needed, and therefore, would not be acceptable as an evaluation. The information obtained from such sources, while insufficient as an evaluation, may be useful to develop an evaluation or appraisal.

An institution should establish policies and procedures for determining an appropriate collateral-valuation method for a given transaction considering associated risks. These policies and procedures should address the process for selecting the appropriate valuation method for a transaction rather than using the method that renders the highest value, lowest cost, or fastest turnaround time.

A valuation method should address the property’s actual physical condition and characteristics as well as the economic and market conditions that affect the estimate of the collateral’s market value. It would not be acceptable for an institution to base an evaluation on unsupported assumptions, such as a property is in “average” condition, the zoning will change, or the property is not affected by adverse market conditions. Therefore, an institution should establish criteria for determining the level and extent of research or inspection necessary to ascertain the property’s actual physical condition, and the economic and market factors that should be considered in developing an evaluation. An institution should consider performing an inspection to ascertain the actual physical condition of the property and market factors that affect its market value. When an inspection is not performed, an institution should be able to demonstrate how these property and market factors were determined.

## EVALUATION CONTENT

An evaluation should contain sufficient information detailing the analysis, assumptions, and conclusions to support the credit decision. An evaluation’s content should be documented in the credit file or reproducible. The evaluation should, at a minimum,

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27. Dodd-Frank Act, section 1473(r).



- Identify the location of the property.
- Provide a description of the property and its current and projected use.
- Provide an estimate of the property's market value in its actual physical condition, use and zoning designation as of the effective date of the evaluation (that is, the date that the analysis was completed), with any limiting conditions.
- Describe the method(s) the institution used to confirm the property's actual physical condition and the extent to which an inspection was performed.
- Describe the analysis that was performed and the supporting information that was used in valuing the property.
- Describe the supplemental information that was considered when using an analytical method or technological tool.
- Indicate all source(s) of information used in the analysis, as applicable, to value the property, including:
  - External data sources (such as market sales databases and public tax and land records);
  - Property-specific data (such as previous sales data for the subject property, tax assessment data, and comparable sales information);
  - Evidence of a property inspection;
  - Photos of the property;
  - Description of the neighborhood; or
  - Local market conditions.
- Include information on the preparer when an evaluation is performed by a person, such as the name and contact information, and signature (electronic or other legally permissible signature) of the preparer.

(See “Appendix B—Evaluations Based on Analytical Methods or Technological Tools” for guidance on the appropriate use of analytical methods and technological tools for developing an evaluation.)

## VALIDITY OF APPRAISALS AND EVALUATIONS

The Board allows an institution to use an existing appraisal or evaluation to support a subsequent transaction in certain circumstances. Therefore, an institution should establish criteria for assessing whether an existing appraisal or

evaluation continues to reflect the market value of the property (that is, remains valid). Such criteria will vary depending upon the condition of the property and the marketplace, and the nature of the transaction. The documentation in the credit file should provide the facts and analysis to support the institution's conclusion that the existing appraisal or evaluation may be used in the subsequent transaction. A new appraisal or evaluation is necessary if the originally reported market value has changed due to factors such as

- passage of time;
- volatility of the local market;
- changes in terms and availability of financing;
- natural disasters;
- limited or over supply of competing properties;
- improvements to the subject property or competing properties;
- lack of maintenance of the subject or competing properties;
- changes in underlying economic and market assumptions, such as capitalization rates and lease terms;
- changes in zoning, building materials, or technology; and
- environmental contamination.

## REVIEWING APPRAISALS AND EVALUATIONS

The Board's appraisal regulations specify that appraisals for federally related transactions must contain sufficient information and analysis to support an institution's decision to engage in the credit transaction. For certain transactions that do not require an appraisal, the Board's regulations require an institution to obtain an appropriate evaluation of real property collateral that is consistent with safe and sound banking practices.

As part of the credit approval process and prior to a final credit decision, an institution should review appraisals and evaluations to ensure that they comply with the Board's appraisal regulations and are consistent with supervisory guidance and its own internal policies. This review also should ensure that an appraisal or evaluation contains sufficient information and analysis to support the decision to engage in the transaction.

Through the review process, the institution should be able to assess the reasonableness of

the appraisal or evaluation, including whether the valuation methods, assumptions, and data sources are appropriate and well supported. An institution may use the review findings to monitor and evaluate the competency and ongoing performance of appraisers and persons who perform evaluations. (See the discussion in the “Selection of Appraisers or Persons Who Perform Evaluations” subsection above.)

When an institution identifies an appraisal or evaluation that is inconsistent with the Board’s appraisal regulations and the deficiencies cannot be resolved with the appraiser or person who performed the evaluation, the institution must obtain an appraisal or evaluation that meets the regulatory requirements prior to making a credit decision. Though a reviewer cannot change the value conclusion in the original appraisal, an appraisal review performed by an appropriately qualified and competent state-certified or state-licensed appraiser in accordance with USPAP may result in a second opinion of market value. An institution may rely on the second opinion of market value obtained through an acceptable USPAP-compliant appraisal review to support its credit decision.

An institution’s policies and procedures for reviewing appraisals and evaluations, at a minimum, should

- address the independence, educational and training qualifications, and role of the reviewer;
- reflect a risk-focused approach for determining the depth of the review;
- establish a process for resolving any deficiencies in appraisals or evaluations; and
- set forth documentation standards for the review and resolution of noted deficiencies.

## Reviewer Qualifications

An institution should establish qualification criteria for persons who are eligible to review appraisals and evaluations. Persons who review appraisals and evaluations should be independent of the transaction and have no direct or indirect interest, financial or otherwise, in the property or transaction, and be independent of and insulated from any influence by loan-production staff. Reviewers also should possess the requisite education, expertise, and competence to perform the review commensurate with the complexity of the transaction, type of real

property, and market. Further, reviewers should be capable of assessing whether the appraisal or evaluation contains sufficient information and analysis to support the institution’s decision to engage in the transaction.

A small or rural institution or branch with limited staff should implement prudent safeguards for reviewing appraisals and evaluations when absolute lines of independence cannot be achieved. Under these circumstances, the review may be part of the originating loan officer’s overall credit analysis, as long as the originating loan officer abstains from directly or indirectly approving or voting to approve the loan.

An institution should assess the level of in-house expertise available to review appraisals for complex projects, high-risk transactions, and out-of-market properties. An institution may find it appropriate to employ additional personnel or engage a third party to perform the reviews. When using a third party, an institution remains responsible for the quality and adequacy of the review process, including the qualification standards for reviewers. (See the discussion in the “Third-Party Arrangements” subsection below.)

## Depth of Review

An institution should implement a risk-focused approach for determining the depth of the review needed to ensure that appraisals and evaluations contain sufficient information and analysis to support the institution’s decision to engage in the transaction. This process should differentiate between high- and low-risk transactions so that the review is commensurate with the risk. The depth of the review should be sufficient to ensure that the methods, assumptions, data sources, and conclusions are reasonable, well supported, and appropriate for the transaction, property, and market. The review also should consider the process through which the appraisal or evaluation is obtained, either directly by the institution or from another financial services institution. The review process should be commensurate with the type of transaction as discussed below:

- *Commercial Real Estate.* An institution should ensure that appraisals or evaluations for commercial real estate transactions are subject to an appropriate level of review. Transactions

involving complex properties or high-risk commercial loans should be reviewed more comprehensively to assess the technical quality of the appraiser's analysis. For example, an institution should perform a more comprehensive review of transactions involving large-dollar credits, loans secured by complex or specialized properties, and properties outside the institution's traditional lending market. Persons performing such reviews should have the appropriate expertise and knowledge relative to the type of property and its market.

The depth of the review of appraisals and evaluations completed for commercial properties securing lower-risk transactions may be less technical in nature, but still should provide meaningful results that are commensurate with the size, type, and complexity of the underlying credit transaction. In addition, an institution should establish criteria for when to expand the depth of the review.

- *One- to Four-Family Residential Real Estate.* The reviews for residential real estate transactions should reflect a risk-focused approach that is commensurate with the size, type, and complexity of the underlying credit transaction, as well as loan and portfolio risk characteristics. These risk factors could include debt-to-income ratios, loan-to-value ratios, level of documentation, transaction dollar amount, or other relevant factors. With prior approval from its primary federal regulator, an institution may employ various techniques, such as automated tools or sampling methods, for performing pre-funding reviews of appraisals or evaluations supporting lower risk residential mortgages. When using such techniques, an institution should maintain sufficient data and employ appropriate screening parameters to provide adequate quality assurance and should ensure that the work of all appraisers and persons performing evaluations is periodically reviewed. In addition, an institution should establish criteria for when to expand the depth of the review.

An institution may use sampling and audit procedures to verify the seller's representations and warranties that the appraisals for the underlying loans in a pool of residential loans satisfy the Board's appraisal regulations and are consistent with supervisory guidance and an institution's internal policies. If an institution is unable to confirm that the appraisal meets the Board's appraisal requirements, then the institution must obtain an appraisal prior

to engaging in the transaction.

- *Appraisals from Other Financial Services Institutions.*<sup>28</sup> The Board's appraisal regulations specify that an institution may use an appraisal that was prepared by an appraiser engaged directly by another financial services institution, provided the institution determines that the appraisal conforms to the Board's appraisal regulations and is otherwise acceptable. An institution should assess whether to use the appraisal prior to making a credit decision. An institution should subject such appraisals to at least the same level of review that the institution performs on appraisals it obtains directly for similar properties and document its review in the credit file. The documentation of the review should support the institution's reliance on the appraisal. Among other considerations, an institution should confirm that
  - the appraiser was engaged directly by the other financial services institution;
  - the appraiser had no direct, indirect, or prospective interest, financial or otherwise, in the property or transaction; and
  - the financial services institution (not the borrower) ordered the appraisal. For example, an engagement letter should show that the financial services institution, not the borrower, engaged the appraiser.

An institution must not accept an appraisal that has been readdressed or altered by the appraiser with the intent to conceal the original client. Altering an appraisal report in a manner that conceals the original client or intended users of the appraisal is misleading, does not conform to USPAP, and violates the Board's appraisal regulations.

## Resolution of Deficiencies

An institution should establish policies and procedures for resolving any inaccuracies or weaknesses in an appraisal or evaluation identified through the review process, including procedures for:

<sup>28</sup>. An institution generally should not rely on an evaluation prepared by or for another financial services institution because it will not have sufficient information relative to the other institution's risk-management practices for developing evaluations.



- Communicating the noted deficiencies to and requesting correction of such deficiencies by the appraiser or person who prepared the evaluation. An institution should implement adequate internal controls to ensure that such communications do not result in any coercion or undue influence on the appraiser or person who performed the evaluation.
- Addressing significant deficiencies in the appraisal that could not be resolved with the original appraiser by obtaining a second appraisal or relying on a review that complies with Standards Rule 3 of USPAP and is performed by an appropriately qualified and competent state-certified or state-licensed appraiser prior to the final credit decision.
- Replacing evaluations prior to the credit decision that do not provide credible results or lack sufficient information to support the final credit decision.

## Documentation of the Review

An institution should establish policies for documenting the review of appraisals and evaluations in the credit file. Such policies should address the level of documentation needed for the review, given the type, risk, and complexity of the transaction. The documentation should describe the resolution of any appraisal or evaluation deficiencies, including reasons for obtaining and relying on a second appraisal or evaluation. The documentation also should provide an audit trail that documents the resolution of noted deficiencies or details the reasons for relying on a second opinion of market value.

## THIRD-PARTY ARRANGEMENTS

An institution that engages a third party to perform certain collateral-valuation functions on its behalf is responsible for understanding and managing the risks associated with the arrangement. An institution should use caution if it engages a third party to administer any part of its appraisal and evaluation function, including ordering or reviewing appraisals and evaluations, selecting an appraiser or person to perform evaluations, or providing access to analytical methods or technological tools.

An institution is accountable for ensuring that any services performed by a third party, both

affiliated and unaffiliated entities, comply with applicable laws and regulations and are consistent with supervisory guidance.<sup>29</sup> Therefore, an institution should have the resources and expertise necessary for performing ongoing oversight of third-party arrangements.

An institution should have internal controls for identifying, monitoring, and managing the risks associated with using a third-party arrangement for valuation services, including compliance, legal, reputational, and operational risks. While the arrangement may allow an institution to achieve specific business objectives, such as gaining access to expertise not available internally, the reduced operational control over outsourced activities poses additional risk. Consistent with safe and sound practices, an institution should have a written contract that clearly defines the expectations and obligations of both the financial institution and the third party, including that the third party will perform its services in compliance with the Board's appraisal regulations and consistent with supervisory guidance.

Prior to entering into any arrangement with a third party for valuation services, an institution should compare the risks, costs, and benefits of the proposed relationship to those associated with using another vendor or conducting the activity in-house. The decision to outsource any part of the collateral-valuation function should not be unduly influenced by any short-term cost savings. An institution should take into account all aspects of the long-term effect of the relationship, including the managerial expertise and associated costs for effectively monitoring the arrangement on an ongoing basis.

If an institution outsources any part of the collateral-valuation function, it should exercise appropriate due diligence in the selection of a third party. This process should include sufficient analysis by the institution to assess whether the third-party provider can perform the services consistent with the institution's performance standards and regulatory requirements. An institution should be able to demonstrate that its policies and procedures establish effective internal controls to monitor and periodically assess the collateral-valuation functions performed by a third party.

<sup>29</sup> See, for example, FFIEC statement, *Risk Management of Outsourced Technology Service* (November 28, 2000) for guidance on the assessment, selection, contract review, and monitoring of a third party that provides services to a regulated institution. Refer to the institution's primary federal regulator for additional guidance on third-party arrangements.

An institution also is responsible for ensuring that a third party selects an appraiser or a person to perform an evaluation who is competent and independent, has the requisite experience and training for the assignment, and thorough knowledge of the subject property's market. Appraisers must be appropriately certified or licensed, but this minimum credentialing requirement, although necessary, is not sufficient to determine that an appraiser is competent to perform an assignment for a particular property or geographic market.

An institution should ensure that when a third party engages an appraiser or a person who performs an evaluation, the third party conveys to that person the intended use of the appraisal or evaluation and that the regulated institution is the client. For example, an engagement letter facilitates the communication of this information.

An institution's risk-management system should reflect the complexity of the outsourced activities and associated risk. An institution should document the results of ongoing monitoring efforts and periodic assessments of the arrangement(s) with a third party for compliance with applicable regulations and consistency with supervisory guidance and its performance standards. If deficiencies are discovered, an institution should take remedial action in a timely manner.

## PROGRAM COMPLIANCE

Deficiencies in an institution's appraisal and evaluation program that result in violations of the Board's appraisal regulations or contraventions of the Board's supervisory guidance reflect negatively on management. An institution's appraisal and evaluation policies should establish internal controls to promote an effective appraisal and evaluation program. The compliance process should

- maintain a system of adequate controls, verification, and testing to ensure that appraisals and evaluations provide credible market values;
- insulate the persons responsible for ascertaining the compliance of the institution's appraisal and evaluation function from any influence by loan-production staff;
- ensure the institution's practices result in the selection of appraisers and persons who perform evaluations with the appropriate qualifi-

cations and demonstrated competency for the assignment;

- establish procedures to test the quality of the appraisal and evaluation review process;
- use, as appropriate, the results of the institution's review process and other relevant information as a basis for considering a person for a future appraisal or evaluation assignment; and
- report appraisal and evaluation deficiencies to appropriate internal parties and, if applicable, to external authorities in a timely manner.

## Monitoring Collateral Values

Consistent with the Board's real estate lending regulations and guidelines,<sup>30</sup> an institution should monitor collateral risk on a portfolio and on an individual credit basis. Therefore, an institution should have policies and procedures that address the need for obtaining current collateral-valuation information to understand its collateral position over the life of a credit and effectively manage the risk in its real estate credit portfolios. The policies and procedures also should address the need to obtain current valuation information for collateral supporting an existing credit that may be modified or considered for a loan workout.

Under their appraisal regulations, the Board reserves the right to require an institution to obtain an appraisal or evaluation when there are safety and soundness concerns on an existing real estate secured credit. Therefore, an institution should be able to demonstrate that sufficient information is available to support the current market value of the collateral and the classification of a problem real estate credit. When such information is not available, an examiner may direct an institution to obtain a new appraisal or evaluation in order to have sufficient information to understand the current market value of the collateral. Examiners would be expected to provide an institution with a reasonable amount of time to obtain a new appraisal or evaluation.

## Portfolio Collateral Risk

Prudent portfolio-monitoring practices include criteria for determining when to obtain a new

30. See 12 CFR 208, subpart E.

appraisal or evaluation. Among other considerations, the criteria should address deterioration in the credit since origination or changes in market conditions. Changes in market conditions could include material changes in current and projected vacancy, absorption rates, lease terms, rental rates, and sale prices, including concessions and overruns and delays in construction costs. Fluctuations in discount or direct capitalization rates also are indicators of changing market conditions.

In assessing whether changes in market conditions are material, an institution should consider the individual and aggregate effect of these changes on its collateral protection and the risk in its real estate lending programs or credit portfolios. Moreover, as an institution's reliance on collateral becomes more important, its policies and procedures should

- ensure that timely information is available to management for assessing collateral and associated risk;
- specify when new or updated collateral valuations are appropriate or desirable to understand collateral risk in the transaction(s); and
- delineate the valuation method to be employed after considering the property type, current market conditions, current use of the property, and the relevance of the most recent appraisal or evaluation in the credit file.

Consistent with sound collateral-valuation monitoring practices, an institution can use a variety of techniques for monitoring the effect of collateral-valuation trends on portfolio risk. Sources of relevant information may include external market data, internal data, or reviews of recently obtained appraisals and evaluations. An institution should be able to demonstrate that it has sufficient, reliable, and timely information on market trends to understand the risk associated with its lending activity.

## Modifications and Workouts of Existing Credits

An institution may find it appropriate to modify a loan or to engage in a workout with an existing borrower. The Board expects an institution to consider current collateral valuation information to assess its collateral risk and facilitate an informed decision on whether to engage in a

modification or workout of an existing real estate credit. (See the discussion above under "Portfolio Collateral Risk.")

- *Loan Modifications.* A loan modification to an existing credit that involves a limited change<sup>31</sup> in the terms of the note or loan agreement and that does not adversely affect the institution's real estate collateral protection after the modification does not rise to the level of a new real estate-related financial transaction for purposes of the Board's appraisal regulations. As a result, an institution would not be required to obtain either a new appraisal or evaluation to comply with the Board's appraisal regulations, but should have an understanding of its collateral risk. For example, institutions can use automated valuation models or other valuation techniques when considering a modification to a residential mortgage loan. An institution should have procedures for ensuring an alternative collateral-valuation method provides reliable information. In addition, an institution should be able to demonstrate that a modification reflects prudent underwriting standards and is consistent with safe and sound lending practices. Examiners will assess the adequacy of valuation information an institution uses for loan modifications.
- *Loan Workouts.* As noted above under "Monitoring Collateral Values," an institution's policies and procedures should address the need for current information on the value of real estate collateral supporting a loan workout. A loan workout can take many forms, including a modification that adversely affects the institution's real estate collateral protection after the modification, a renewal or extension of loan terms, the advancement of new monies, or a restructuring with or without concessions. These types of loan workouts are new real estate-related financial transactions.

If the loan workout does not include the advancement of new monies other than reasonable closing costs, the institution may

31. A loan modification that entails a decrease in the interest rate or a single extension of a limited or short-term nature would not be viewed as a subsequent transaction. For example, an extension arising from a short-term delay in the full repayment of the loan when there is documented evidence that payment from the borrower is forthcoming, or a brief delay in the scheduled closing on the sale of a property when there is evidence that the closing will be completed in the near term.

obtain an evaluation in lieu of an appraisal. For loan workouts that involve the advancement of new monies, an institution may obtain an evaluation in lieu of an appraisal provided there has been no obvious and material change in market conditions and no change in the physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the workout.

In these cases, an institution should support and document its rationale for using this exemption. An institution must obtain an appraisal when a loan workout involves the advancement of new monies and there is an obvious and material change in either market conditions or physical aspects of the property, or both, that threatens the adequacy of the institution's real estate collateral protection after the workout (unless another exemption applies).<sup>32</sup> (See also "Appendix A—Appraisal Exemptions" for transactions where an evaluation would be allowed in lieu of an appraisal.)

- *Collateral-Valuation Policies for Modifications and Workouts.* An institution's policies should address the need for obtaining current collateral-valuation information for a loan modification or workout. The policies should specify the valuation method to be used and address the need to monitor collateral risk on an ongoing basis taking into consideration changing market conditions and the borrower's repayment performance. An institution also should be able to demonstrate that the collateral-valuation method used is reliable for a given credit or loan type.

Further, for loan workouts, an institution's policies should specify conditions under which an appraisal or evaluation will be obtained. As loan repayment becomes more dependent on the sale of collateral, an institution's policies should address the need to obtain an appraisal or evaluation for safety and soundness reasons even though one is not otherwise required by the Board's appraisal regulations.

licensed appraiser failed to comply with USPAP, applicable state laws, or engaged in other unethical or unprofessional conduct. In addition, effective April 1, 2011, an institution must file a complaint with the appropriate state appraiser certifying and licensing agency under certain circumstances.<sup>33</sup>

An institution also must file a suspicious activity report (SAR) with the Financial Crimes Enforcement Network of the Department of the Treasury (FinCEN) when suspecting fraud or identifying other transactions meeting the SAR filing criteria.<sup>34</sup> Examiners finding evidence of unethical or unprofessional conduct by appraisers should instruct the institution to file a complaint with state appraiser regulatory officials and, when required, to file a SAR with FinCEN. If there is a concern regarding the institution's ability or willingness to file a complaint or make a referral, examiners should forward their findings and recommendations to their supervisory office for appropriate disposition and referral to state appraiser regulatory officials and FinCEN, as necessary.

## APPENDIXES IN INTERAGENCY APPRAISAL AND EVALUATION GUIDELINES

There are four appendixes included with the guidelines. They are summarized below and can be found in section A. 4140.1 of this manual.

*Appendix A—Appraisal Exemptions:* A commentary on the 12 exemptions from the agencies' appraisal regulations. The appendix provides an explanation of the agencies' statutory authority to provide for appraisal regulatory exemptions and the application of these exemptions.

*Appendix B—Evaluations Based on Analytical Methods and Technological Tools:* A discussion of the agencies' expectations for evaluations that are based on analytical methods and tech-

## REFERRALS

An institution should file a complaint with the appropriate state appraiser regulatory officials when it suspects that a state-certified or state-

<sup>32</sup> For example, if the transaction value is below the appraisal threshold of \$250,000.

<sup>33</sup> See 12 CFR 226.42(g).

<sup>34</sup> Refer to 12 CFR 208.62, 211.5(k), 211.24(f), and 225.4(f). Refer also to the *Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering Examination Manual* (revised April 29, 2010) to review the general criteria, but note that instructions on filing a SAR through the Financial Crime Enforcement Network (FinCEN) of the Department of the Treasury are attached to the SAR form. The SAR form is available on FinCEN's website: [www.fincen.gov/forms/bsa\\_forms/#SAR](http://www.fincen.gov/forms/bsa_forms/#SAR).

nological tools, including the use of automated valuation models and tax assessment valuations.

*Appendix C—Deductions and Discounts Minimum:* A discussion on appraisal standards for determining the market value of a residential tract development, including an explanation of the requirement to analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units.

*Appendix D—Glossary:* Definitions of terms related to real estate lending, appraisals, and regulations to aid in the reading of the guidelines.

## BACKGROUND INFORMATION ON APPRAISAL VALUATION APPROACHES

An appraiser typically utilizes three market-value approaches to analyze the value of property:

- cost approach
- sales comparison approach
- income approach

All three approaches have particular merits depending upon the type of real estate being appraised. For single-family residential property, the cost and comparable sales approaches are most frequently used since the common use of the property is the personal residence of the owner. However, if a single-family residential property is intended to be used as a rental property, the appraiser would have to consider the income approach as well. For special-use commercial properties, the appraiser may have difficulty obtaining sales data on comparable properties and may have to base the value estimate on the cost and income approaches.

If an approach is not used in the appraisal, the appraiser should disclose the reason the approach was not used and whether this affects the value estimate.

### Cost Approach

In the cost approach to value estimation, the appraiser obtains a preliminary indication of

value by adding the estimated depreciated reproduction cost of the improvements to the estimated land value. This approach is based on the assumption that the reproduction cost is the upper limit of value and that a newly constructed building would have functional and mechanical advantages over an existing building. The appraiser would evaluate any functional depreciation (disadvantages or deficiencies) of the existing building in relation to a new structure.

The cost approach consists of four basic steps: (1) estimate the value of the land as though vacant, (2) estimate the current cost of reproducing the existing improvements, (3) estimate depreciation and deduct from the reproduction cost estimate, and (4) add the estimate of land value and the depreciated reproduction cost of improvements to determine the value estimate.

### Sales Comparison Approach

The essence of the sales comparison approach is to determine the price at which similar properties have recently sold on the local market. Through an appropriate adjustment for differences in the subject property and the selected comparable properties, the appraiser estimates the market value of the subject property based on the sales price of the comparable properties. The process used in determining the degree of comparability of two or more properties involves judgment about their similarity with respect to age, location, condition, construction, layout, and equipment. The sales price or list price of those properties deemed most comparable tend to set the range for the value of the subject property.

### Income Approach

The income approach estimates the project's expected income over time converted to an estimate of its present value. The income approach is typically used to determine the market value of income-producing properties such as office buildings, apartment complexes, hotels, and shopping centers. In the income approach, the appraiser can use several different capitalization or discounted cash-flow techniques to arrive at a market value. These techniques include the band-of-investments method,



mortgage-equity method, annuity method, and land-residual technique. Which technique is used depends on whether there is project financing, whether there are long-term leases with fixed-level payments, and whether the value is being rendered for a component of the project such as land or buildings.

The accuracy of the income-approach method depends on the appraiser's skill in estimating the anticipated future net income of the property and in selecting the appropriate capitalization rate and discounted cash flow. The following data are assembled and analyzed to determine potential net income and value:

- Rent schedules and the percentage of occupancy for the subject property and for comparable properties for the current year and several preceding years. This provides gross rental data and shows the trend of rentals and occupancy, which are then analyzed by the appraiser to estimate the gross income the property should produce.
- Expense data such as taxes, insurance, and operating costs paid from revenues derived from the subject property and by comparable properties. Historical trends in these expense items are also determined.
- A time frame for achieving stabilized, or normal, occupancy and rent levels (also referred to as a holding period).

Basically, the income approach converts all expected future net operating income into present-value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is used to value income properties. This method calculates the value of a property by dividing an estimate of its stabilized annual income by a factor called a cap rate. Stabilized income is generally defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The cap rate—usually defined for each property type in a market area—is viewed by some analysts as the required rate of return stated as a percent of current income.

The use of this technique assumes that the use of either the stabilized income or the cap rate accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate

of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization should yield the same results.

For special-use properties, new projects, or troubled properties, the discounted cash flow (net present value) method is the more typical approach to analyzing a property's value. In this method, a time frame for achieving a stabilized, or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Most importantly, the analysis should be based on the ability of the project to generate income over time based upon reasonable and supportable assumptions. Additionally, the discount rate should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions.

## Value Correlation

The three value estimates—cost, sales comparison, and income—must be evaluated by the appraiser and correlated into a final value estimate based on the appraiser's judgment. Correlation does not imply averaging the value estimates obtained by using the three different approaches. Where these value estimates are relatively close together, correlating them and setting the final market value estimate presents no special problem. It is in situations where widely divergent values are obtained by using the three appraisal approaches that the examiner must exercise judgment in analyzing the results and determining the estimate of market value.

## Other Definitions of Value

While the Board's appraisal regulation requires that the appraisal contain the market value of the real estate collateral, there are other definitions

of value that are encountered in appraising and evaluating real estate transactions. These include the following.

*Fair Value.* This is an accounting term that is generally defined as the amount in cash or cash-equivalent value of other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (the selling price), that is, other than in a forced or liquidation sale.<sup>35</sup> According to accounting literature, fair value is generally used in valuing assets in nonmonetary transactions, troubled debt restructuring, quasi-reorganizations, and business combinations accounted for by the purchase method. An accountant generally defines fair value as market value; however, depending on the circumstances, these values may not be the same for a particular property.

*Investment Value.* This is based on the data and assumptions that meet the criteria and objectives of a particular investor for a specific property or project. The investor's criteria and objectives are often substantially different from participants' criteria and objectives in a broader market. Thus, investment value can be significantly higher than market value in certain circumstances and should not be used in credit analysis decisions.

*Liquidation Value.* This assumes that there is little or no current demand for the property but the property needs to be disposed of quickly, resulting in the owner sacrificing potential property appreciation for an immediate sale.

*Going-Concern Value.* This is based on the value of a business entity rather than the value of just the real estate. The valuation is based on

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35. See Accounting Standards Codification (ASC) Topic 820, "Fair Value Measurements and Disclosures" (formerly FASB Statement No. 157, "Fair Value Measurements"). It defines fair value and establishes a framework for measuring fair value. ASC Topic 820 should be applied when other accounting topics require or permit fair value measurements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the asset's or liability's principal (or most advantageous) market at the measurement date. This value is often referred to as an "exit" price. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced liquidation or distressed sale.

the existing operations of the business that has a proven operating record, with the assumption that the business will continue to operate.

*Assessed Value.* This represents the value on which a taxing authority bases its assessment. The assessed value and market value may differ considerably due to tax assessment laws, timing of reassessments, and tax exemptions allowed on properties or portions of a property.

*Net Realizable Value (NRV).* This is recognized under generally accepted accounting principles as the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining the selling price), holding, and disposal. The NRV is generally used to evaluate the carrying amount of assets being held for disposition and properties representing collateral. While the market value or future selling price are generally used as the basis for the NRV calculation, the NRV also reflects the current owner's costs to complete the project and to hold and dispose of the property. For this reason, the NRV will generally be less than the market value.

## SUPERVISORY EXPECTATIONS AND FINDINGS

In conjunction with assessing overall adequacy of a bank's appraisal and evaluation function to support safe and sound real estate lending, examiners should review the bank for compliance with the Board's appraisal regulation and related guidelines. When citing a violation of the appraisal regulation for a state member bank, an examiner should note the matter as a violation of Regulation H (12 CFR 208, subpart E) citing the provision as codified in Regulation Y. In some instances, the finding may indicate that the bank has failed to comply with the Board's real estate lending standards regulation and guidelines (See 12 CFR 208, Appendix C). The following summarizes possible examination findings and references to the applicable provisions in the Board's regulations or relevant section in the Interagency Guidelines.

- *Bank's appraisal function is weak:*
  - The bank has failed to satisfy supervisory expectations as indicated in the Inter-

- agency Appraisal and Evaluation Guidelines. See the “Appraisal and Evaluation Program” subsection above.
- *Bank does not have adequate procedures for monitoring market conditions for its CRE lending:*
    - A bank must monitor real estate market conditions in its lending area and have credit administration policies that address the type and frequency of collateral valuations. Violation of 12 CFR 208, subpart E (real estate lending standards regulation and guidelines).
    - The bank has failed to comply with the Interagency Guidelines. See the “Monitoring Collateral Values” subsection above.
  - *Appraisal fails to comply with regulation:*
    - Violation of 12 CFR 208.50, subpart E as set forth in 12 CFR 225.64 (minimum appraisal standards) or 12 CFR 225.65 (appraiser independence).
    - Examiners may require the bank to obtain a new appraisal for safety-and-soundness reasons (12 CFR 225.63(c)).
  - *The bank fails to obtain an appraisal as required by the regulation:*
    - Violation of 12 CFR 208, subpart E as set forth in 12 CFR 225.63(a).
    - The bank must obtain an appraisal.
      - For further background, refer to the Interagency Guidelines, the “Transactions That Require Appraisals” subsection, and Appendix A—Appraisal Exemptions.
  - *The bank fails to obtain an evaluation for certain exempted transactions:*
    - Violation of 12 CFR 208, subpart E as set forth in 12 CFR 225.63(b) (see the provision on evaluations required).
    - For further background, refer to the Interagency Guidelines and the section on “Transactions That Require Evaluations” as well as Appendix A—Appraisal Exemptions.
    - The bank must obtain an evaluation.
  - *The evaluation is inadequate:*
    - The bank has failed to satisfy supervisory expectations as indicated in the Interagency Appraisal and Evaluation Guidelines.
      - For further background, refer to the Interagency Guidelines, the “Evaluation Development” and “Evaluation Content” subsections, and Appendix B—Evaluations Based on Analytical Methods or Technological Tools.
    - Depending upon the noted deficiencies, examiners should require the bank to perform a new evaluation.



# Real Estate Appraisals and Evaluations

## Examination Objectives

Effective date April 2011

## Section 4140.2

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1. To determine whether policies, practices, procedures, and internal controls regarding real estate appraisals and evaluations for real estate–related financial transactions are adequate.
2. To determine whether bank officers and employees are operating in conformance with the board of director’s appraisal policies and that such policies promote compliance with the appraisal regulations and related-supervisory guidance and independence between the appraisal and evaluation process and the loan production function (i.e., the credit decision).
3. To determine whether the bank’s policies and procedures address the requirement to monitor real estate collateral values and market conditions on a portfolio basis and over the life of the credit.
4. To determine that appraisals performed in connection with federally related transactions comply with the minimum standards of the Board’s regulation and the Uniform Standards of Professional Appraisal Practice.
5. To determine that the bank’s policies and practices for performing evaluations comply with supervisory guidance and ensure that qualified individuals perform evaluations.
6. To determine whether the bank has effective policies and procedures for the review of appraisals and evaluations, including procedures for addressing deficiencies.
7. To determine that appraisers used in connection with federally related transactions hold a valid state license or certification as applicable for the property being appraised.
8. To determine that appraisers are competent to render appraisals in federally related transactions, and are independent of the transaction, or other lending, investment, or collection functions as appropriate.
9. To determine that the bank has appropriate oversight over any third party providing appraisal management services.
10. To determine that the bank has appropriate policies and procedures governing the use of analytical methods and technological tools in the preparation of evaluations.
11. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations or noncompliance with provisions of supervisory guidelines have been noted.

# Real Estate Appraisals and Evaluations

## Examination Procedures

Effective date April 2011

## Section 4140.3

1. On the basis of the evaluation of internal controls and the work performed by internal or external auditors, or examination findings from the bank's real estate lending activity, determine the scope of the examination.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any deficiencies noted in the latest review performed by internal or external auditors or a previous examination report and determine if appropriate corrections have been made.
  - a. Provide copies of the bank's appraisal and evaluation policies and procedures to examiners assigned to functional areas in which real estate-related transactions may require the services of an appraiser or evaluator.
  - b. When individual real estate-related transactions such as loan or other real estate owned (OREO) transactions are examined, appraisals and evaluations should be reviewed for compliance with the Board's appraisal regulation, supervisory guidance, and the bank's appraisal and evaluation programs.
  - c. When real estate-related transactions are examined on a portfolio basis, the appraisal and evaluation processes for the activity should be examined. Examiners should determine whether these processes ensure that appraisals and evaluations comply with the Board's appraisal regulation, supervisory guidance, and the bank's appraisal and evaluation programs.
3. Review the appraisal and evaluation program and determine the following:
  - a. The board of directors has adopted policies and procedures that—
    - establish and maintain an effective, independent appraisal and evaluation program for all of the institution's lending functions;
    - are sufficiently comprehensive;
    - require an appropriate level of review of appraisals and evaluations to promote compliance with the Board's appraisal regulation and supervisory guidance as well as safe and sound lending; and
    - are applied uniformly to all units engaged in real estate-related activity.
  - b. The appraisal and evaluation program establishes criteria which the bank uses to select, evaluate, monitor, and ensure the independence of appraisers and the individuals who perform evaluations as well as those individuals who perform and oversee the review of appraisals and evaluations.
  - c. The program considers the independent appraiser's qualifications, experience, and educational background; confirms the appraiser's independence; ensures that appraisals are not used if they were prepared by an individual recommended or selected by the borrower (including those individuals listed by the bank as approved appraisers); and ensures that appraisals conform to the Board's appraisal regulation and are consistent with supervisory guidance.
  - d. The program ensures that evaluations conform to the Board's guidance on evaluations.
  - e. The program is adequate for the bank's size and location and for the nature and complexity of its real estate lending and other real estate-related activities.
  - f. The policies and procedures require that appraisals and evaluations be written and contain sufficient information on the real estate collateral's market value to support the bank's decision to enter into the transaction.
  - g. The program includes policies and procedures concerning the need for current collateral valuation information to understand the bank's collateral position over the life of the credit and to manage risk in its real estate credit portfolio.
  - h. The policies and procedures address the need for current collateral valuation information for loans that the bank is considering for modification or a workout.
  - i. If the program utilizes an approved appraiser list, the bank has appropriate procedures for the development and administration of the list.
  - j. The program addresses appraisal and evaluation review procedures, including

- the communications with the appraiser or the individual who performed the evaluation, resolution of deficiencies, and the decision to obtain a second appraisal or evaluation.
- k. The board or senior management reviews annually its appraisal and evaluation related policies and procedures and records such review in its minutes.
4. Evaluate the bank's appraisal and evaluation program with respect to the following:
    - a. the adequacy of written appraisals and evaluations
    - b. the manner in which bank officers are operating in conformance with established policy
    - c. internal control deficiencies or exceptions, including lack of independence of the appraisal and evaluation process from the loan-production function
    - d. the integrity of the appraisal and evaluation process, including appraisal and evaluation compliance procedures
    - e. the integrity of individual appraisals and evaluations, including the adequacy, reasonableness, and appropriateness of the methods, assumptions, and techniques used and whether the appraisals and evaluations comply with the Board's appraisal regulation and supervisory guidance
    - f. the adequacy of the appraisal and evaluation review practices, including the depth and content of the review, documentation support for the review, and the resolution of deficiencies
    - g. the adequacy of policies and internal controls for managing and monitoring third parties that provide appraisal management services to the bank
    - h. the integrity of policies and procedures governing the use of automated valuation models in the development of evaluations
    - i. the eligibility of the bank to assign a 50 percent risk weight to certain one- to four-family residential mortgage loans for risk-based capital purposes (See section 3020.1, "Assessment of Capital Adequacy.")
    - j. recommended corrective action when policies, practices, or procedures are found to be deficient
    - k. the degree of violations, if any, of the Board's appraisal regulation and the extent of noncompliance with supervisory guidance, if noted
  - l. other matters of significance:
    - misrepresentation of data, such as the omission of information on favorable financing, seller concessions, sales history, market conditions, property's current performance (i.e., occupancy and rental rate), project feasibility (i.e., lease or sale absorption rate), zoning, easements, or deed restrictions
    - inadequate techniques of analysis, that is, failure to use the cost, comparable-sales, or income approach in an appraisal when the approach is appropriate for the type of property
    - use of dissimilar comparables in the comparable-sales approach to valuation, for example, the age, size, quality, or location of the comparable is significantly different from the subject property, making reconciliation of value difficult
    - underestimation of factors such as construction cost, construction period, lease-up period, and rent concessions
    - use of best-case assumptions for the income approach to valuation without performing a sensitivity analysis on the factors that would identify the lender's downside risk
    - overly optimistic assumptions such as a high absorption rate in an overbuilt market or assumptions on discount and capitalization rates that do not reflect market conditions and investor's expected rate of return
    - failure to analyze and report appropriate deductions and discounts when the appraisal provides a market value estimate based on the future demand of the real estate (such as proposed construction, partially leased buildings, non-market lease terms, and unsold units in a residential tract development)
    - the nonreconciliation of demographic factors (such as existing housing inventory, projected completions, and expected market share to the value rendered) and the discussion of demographic factors as background information
    - the opinion of market value includes the value of both real property and non-real property (e.g., furnishings or an intangible asset)
    - lack of documentation on the reasons that an alternative market value was

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- used in the credit decision from the opinion of market value provided in the appraisal or evaluation
5. Report any instances of questionable conduct by appraisers, along with the supporting documentation, to the Reserve Bank for possible referral to the appropriate state appraisal authorities.
  6. Update workpapers with any information that will facilitate future examinations.

# Real Estate Appraisals and Evaluations

## Internal Control Questionnaire

Effective date April 2011

## Section 4140.4

Review the bank's internal controls, policies, practices, and procedures for real estate appraisals and evaluations. The bank's system should be accurately and fully documented and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written appraisal and evaluation policies that define the following:
    - a. bank management's responsibility for selecting, evaluating, monitoring, and ensuring the independence of the individual who is performing the appraisal or evaluation?
    - b. the basis for selecting staff appraisers and engaging fee appraisers for a particular appraisal assignment and for ensuring that the individual is independent of the transaction; possesses the requisite qualifications, expertise, and educational background; demonstrates competency for the market and property type; and has the required state certification or license if applicable?
    - c. procedures for when to obtain appraisals and evaluations?
    - d. procedures for prohibiting the use of a borrower-ordered or borrower-provided appraisal?
    - e. procedures for monitoring collateral risk on a loan and portfolio basis as to when to obtain a new appraisal or new evaluation, including the frequency, triggering events, scope of appraisal work, valuation methods, and report option?
    - f. appraisal and evaluation compliance procedures to determine that appraisals and evaluations are reviewed by qualified and adequately trained individuals who are not involved in the loan-production process?
    - g. appraisal and evaluation review procedures to ensure that the bank's appraisals and evaluations are consistent with the standards of the Uniform Standards of Professional Appraisal Practice (USPAP) and the Board's regulation and guidelines?
  - h. appraisal and evaluation review procedures that require the performance of the review prior to the credit decision, resolution of noted deficiencies, and documentation of the review in the credit file, and, if necessary, obtaining a second appraisal or relying on USPAP's standard rule 3 in performing a review or performing another evaluation?
  - i. an appropriate level of review for appraisals and evaluations ordered by the bank's agents or obtained from another financial services institution?
  - j. adequate level of oversight when the bank uses a third party for appraisal management services?
  - k. use of analytical methods and technological tools (such as automated valuation models or tax assessment valuations) in the development of evaluations that is appropriate for the risk and type of transaction and property?
  - l. internal controls to prevent officers, loan officers, or directors who order or review appraisals and evaluations from having the sole authority for approving the requested loans?
  - m. procedures for promoting compliance with the appraisal independence provisions of Regulation Z (Truth in Lending) for open- and closed-end consumer credit transactions secured by a consumer's principal dwelling?
2. Does the board of directors annually review these policies and procedures to ensure that the appraisal and evaluation policies and procedures meet the needs of the bank's real estate lending activity and remains compliant with the Board's regulation and supervisory guidance?

### APPRAISALS

- \*1. Are appraisals in writing, dated, and signed by the appraiser?
- \*2. Does the appraisal meet the minimum standards of the Board's regulation and

USPAP, and supervisory guidance, containing sufficient information and analysis to support the bank's decision to engage in the transaction? Does the appraisal—

- a. reflect an appropriate scope of work that will provide for credible results, including the extent to which the property is identified and inspected, the type and extent of data research performed, and the analyses applied to arrive at an opinion of market value?
- b. disclose the purpose and use of the appraisal?
- c. provide an opinion of the collateral market value as defined in the Board's appraisal regulation and further clarified in supervisory guidance?
- d. provide an effective date for the opinion of market value?
- e. provide the sales history of the subject property for the prior three years?
- f. reflect valuation approaches (that is, cost, income, and sales comparison approaches) that are applicable for the property type and market?
- g. include an analysis and reporting of appropriate deductions and discounts when the appraisal provides a market value estimate based on the future demand of the real estate (such as proposed construction, partially leased buildings, non-market lease terms, and unsold units in a residential tract development)?
- h. evaluate and reconcile the three approaches into an opinion of market value estimate based on the appraiser's judgment?
- i. explain why an approach is inappropriate and not used in the appraisal?
- j. fully support the assumptions and the value rendered through adequate documentation and information on market conditions and trends?
- k. evaluate key assumptions and potential ramifications to the opinion of market value if these assumptions are not realized?
- l. present an opinion of the collateral's market value in an appraisal report option that addresses the property type, market, risk, and type of transaction?
- m. disclose and define other value opinions (such as disposal value of the property or the value of non-real property), if the

bank requests such information?

- \*3. Are appraisals received before the bank makes its final credit or other credit decision (for example, is the date the loan committee approved the credit later than the date of the appraisal)?
- \*4. If the bank is depending on an appraisal obtained for another financial services institution as support for its transaction, does the bank have appraisal review procedures to ensure that the appraisal meets the standards of the appraisal regulation, including independence? (These types of transactions would include loan participations, loan purchases, and mortgage-backed securities.)
- \*5. If an appraisal for one transaction is used for a subsequent transaction, does the bank sufficiently document its determination that the appraiser is independent, the appraisal complies with the appraisal regulations, and the appraisal is still valid?

## APPRAISERS

1. Are appraisers fairly considered for assignments regardless of their membership or lack of membership in a particular appraisal organization?
2. Before the bank selects an appraiser for an assignment, does the bank confirm that the appraiser has the requisite qualifications, education, experience, and competency for both the property type and market to complete the appraisal?
3. If a bank pre-screens appraisers and uses an approved appraiser list, does the bank have procedures for assessing an appraiser's qualifications, selecting an appraiser for a particular assignment, and evaluating the appraiser's work for retention on the list?
4. The following items apply for large, complex, or out-of-area commercial real estate properties:
  - a. Are written engagement letters used when ordering appraisals, and are copies of the letters retained or included in the appraisal report?
  - b. Does the bank have procedures for determining when such appraisals should be reviewed by another appraiser (that

is, a USPAP standard rule 3 appraisal review)?

5. Are appraisers independent of the transaction?
  - a. Are staff appraisers independent of the lending, investment, and collection functions and not involved, except as an appraiser, in the federally related transaction? Has a determination been made that they have no direct or indirect interest, financial or otherwise, in the property?
  - b. Are fee appraisers engaged directly by the bank or its agent? Has a determination been made that they have no direct or indirect interest, financial or otherwise, in the property or transaction?
  - c. Are any appraisers recommended or selected by the borrower (applicant)?
6. If the bank has staff appraisers to perform appraisals or appraisal reviews, does the bank periodically have independent appraisers evaluate their work for quality and confirm that they have the knowledge and competency to perform their work and continue to hold the appropriate state license or certification?
7. If fee appraisers are used by the bank, does the bank investigate their qualifications, experience, education, background, and reputations?
8. Is the status of an appraiser's state certification or license verified with the state appraiser regulatory authority to ensure that the appraiser is in good standing?
9. Does the bank have procedures for filing complaints with the appropriate state appraiser regulatory officials when it suspects the fee appraiser failed to comply with USPAP, applicable state laws, or engaged in other unethical or unprofessional conduct?
10. Are fee appraisers paid the same fee whether or not the loan is granted?
11. Does the bank pay a customary and reasonable fee for appraisal services in the market where the property is located when the appraisal is for an open- and closed-end consumer credit transaction secured by a consumer's principal dwelling as required under Regulation Z?

## EVALUATIONS

1. Are the individuals performing evaluations independent of the transaction?
- \*2. Are the evaluations required to be in writing, dated, and signed?
- \*3. Does the bank require sufficient information and documentation to support the estimate of value and the individual's analysis?
- \*4. Are the development and content of the evaluation reflective of transaction risk and appropriate for the property type?
- \*5. Are the valuation methods used, and does the supporting information in the evaluation provide a reliable estimate of the property's market value as of a stated effective date prior to the credit decision?
- \*6. If analytical methods or technological tools are used in the development of an evaluation, is the use of the method or tool consistent with safe and sound banking practices and supervisory guidance?
- \*7. If an evaluation obtained for one transaction is used for a subsequent transaction, does the bank sufficiently document its determination that the evaluation is still valid?
- \*8. Are evaluations received before the bank enters into a loan commitment?
- \*9. Does the bank have evaluation review procedures to ensure that the evaluation meets the Board's regulation and guidance?
- \*10. If a tax assessment valuation is used in the development of an evaluation, has the bank demonstrated that there is a valid correlation between the tax assessment data and the property's market value?

## EVALUATORS

1. Are individuals who perform evaluations competent to complete the assignment?
2. Do the individuals who perform evaluations possess the appropriate collateral valuation training, expertise, and experience relevant to the type of property being valued?
3. Are evaluations prepared by individuals who are independent of the transaction?



## MONITORING COLLATERAL VALUES

1. Does the bank have policies to monitor collateral risk on a portfolio and on an individual credit basis?
2. Does the policy address the need to obtain current valuation information for collateral supporting an existing credit that may be modified or considered for a loan workout?
3. Does the criteria for determining when to obtain a new appraisal or new evaluation address deterioration in the credit; material changes in market conditions; and revisions to, or delays in, the project's development and construction?
4. Does the bank sufficiently document and follow its criteria for obtaining reappraisals or reevaluations?

## THIRD PARTY ARRANGEMENTS

1. Did the bank exercise appropriate due diligence in the selection of a third party to perform appraisal management services for the bank?
2. Does the bank have the resources and expertise necessary for performing ongoing oversight of such third party arrangements?
3. Does the bank have the internal controls for identifying, monitoring, and managing the risks associated with the use of the third party?
4. Does the bank adequately document the results of its ongoing monitoring and periodic assessments of the third party's compliance with applicable regulations and consistency with supervisory guidance?
5. Does the bank take timely remedial actions when deficiencies are discovered?
6. Does the bank ensure that the third party selects an appraiser or a person to perform an evaluation who is competent, qualified, independent, and appropriately licensed or certified for a given assignment?
7. Does the bank ensure that the third party conveys to the appraiser or the person who performs the evaluation that the bank is the client?

## ANALYTICAL METHODS AND TECHNOLOGICAL TOOLS

1. Does the bank have staff, or if necessary engage a third party, with the requisite expertise and training to manage the selection, use, and validation of an analytical method or technological tool?
2. Does the bank have adequate policies, procedures, and internal controls governing the selection, use, and validation of the valuation method or tool for the development of an evaluation?
3. Does the bank have appropriate policies and procedures governing the selection of automated valuation model (AVM)? For instance, did the bank:
  - Perform the necessary level of due diligence in selecting an AVM vendor and its models, considering how model developers conducted performance testing as well as the sample size used and the geographic level tested (such as county level or zip code).
  - Establish acceptable minimum performance criteria for a model prior to, and independent of, the validation process.
  - Perform validation of the model(s) during the selection process and document the validation process.
  - Evaluate underlying data used in the model(s), including the data sources and types, frequency of updates, quality control performed on the data, and the sources of the data in states where public real estate sales data are not disclosed.
  - Assess modeling techniques and the inherent strengths and weaknesses of different model types as well as how a model(s) performs for different property types.
  - Evaluate the AVM vendor's scoring system and methodology for the model(s).
  - Determine whether the scoring system provides an appropriate indicator of model reliability by property types and geographic locations.
4. Does the bank have procedures for monitoring the use of an AVM(s), including an ongoing validation process?
5. Does the bank maintain AVM performance criteria for accuracy and reliability in a given transaction, lending activity, and geographic location?



6. Has the bank established a criteria for determining whether a particular valuation method or tool is appropriate for a given transaction or lending activity, considering associated risks, including transaction size and purpose, credit quality, and leverage tolerance (loan-to-value)?
7. Does the criteria consider when market events or risk factors would preclude the use of a particular method or tool?
8. Does the bank have internal controls to preclude “value shopping” when more than one AVM is used for the same property?
9. Do the bank’s policies include standards governing the use of multiple methods or tools, if applicable, for valuing the same property or to support a particular lending activity?
10. Does the bank have appropriate controls to ensure that the selected method or tool produces a reliable estimate of market value that supports the bank’s decision to engage in a transaction?
11. Do the bank’s policies and procedures adequately address the extent to which
  - An inspection or research should be performed to ascertain the property’s actual physical condition, and
  - Supplemental information should be obtained to assess the effect of market conditions or other factors on the estimate of market value.

The Federal Reserve System relies on the timely and accurate filing of regulatory reports by domestic and foreign financial institutions. Data collected from regulatory reports facilitate early identification of problems that can threaten the safety and soundness of reporting institutions; ensure timely implementation of the prompt-corrective-action provisions required by law; and serve other legitimate supervisory purposes. Certain regulatory report information is used for public disclosure so investors, depositors, and creditors can better assess the financial condition of the reporting banks. Information that comes primarily from the Consolidated Reports of Condition and Income (Call Reports) is used to prepare the Uniform Bank Performance Report (UBPR), which employs ratio analyses to detect unusual or significant changes in a bank's financial condition as of the reporting dates. The UBPR is also used to detect changing patterns of behavior in the entire banking system; consequently, any inaccurate data in the regulatory reports may result in ratios that conceal deteriorating trends in the bank or the industry.

Generally, all regulatory reports of financial condition and income that domestic and foreign banking organizations file with the Federal Reserve are required by statute or regulation. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) amended various banking statutes to enhance the Federal Reserve's authority to assess civil money penalties against state member banks, bank holding companies, and foreign institutions that file "late," "false," or "misleading" regulatory reports. The civil money penalties also can be assessed against individuals who cause or participate in such filings.

The Federal Reserve has identified a late regulatory report as an official copy of a report that is not received by the Reserve Bank or its designated electronic collection agent in a timely manner. Each bank must file its Call Report in one of the following two ways:

- The institution may complete its reports in paper form and arrange with a software vendor or another party to convert its paper reports into the electronic format that can be processed by the CDR. The software vendor or other party then must electronically submit the data file containing the bank's Call Report to the CDR.
  - The institution may complete its reports in paper form and arrange with a software vendor or another party to convert its paper reports into the electronic format that can be processed by the CDR. The software vendor or other party then must electronically submit the data file containing the bank's Call Report to the CDR.
- The filing of a Call Report in paper form directly with the FDIC or with the appropriate Federal Reserve Bank is not an acceptable method of submission.
- Reserve Banks will monitor the filing of all regulatory reports to ensure that they are filed, as required, on a timely basis and that they are accurate and not misleading. The Federal Reserve System's Committee on Current Series Reporting, which consists of staff from the statistics functions at each of the Reserve Banks and at the Board, will play an active role in this process. (See SR-04-15.) Many reporting errors can be screened through validity edit checks. Also, Reserve Banks have additional monitoring procedures that they use to confirm the timely submission of reports and to confirm that the reports are accurate and not misleading. On a case-by-case basis, the Reserve Banks will continue to determine if and when a financial institution or other banking organization is a chronic late, inaccurate, or false reporter; in these cases, the Banks will determine what supervisory action, if any, to recommend for a noncompliant reporter.
- The filing of a false report generally involves the submission of mathematically incorrect data, such as addition errors or transpositions, or the submission of a regulatory report without its appropriate schedules. Conversely, the filing of a misleading report involves some degree of negligent behavior on the part of the filer that results in the submission of inaccurate information to the Federal Reserve.

### REVIEW AND REFILING OF REGULATORY REPORTS

Review of regulatory reports involves determining whether the management of the member bank has submitted all required reports to the Federal Reserve in a timely and accurate man-

ner. The examiner assigned to a specific area of examination is responsible for reviewing the reports relating to that area and for verifying that they are accurate and meet statutory and regulatory requirements. If the examiner finds a material difference in the reports, management should be instructed to refile corrected copies, if appropriate.

Examiners should discuss on the “Examination Conclusions and Comments” and “Matters Requiring Board Attention” pages of the examination report material errors or the filing of chronically late reports. (See section 6000.1.) They should also discuss with Reserve Bank staff any regulatory report filing that is considered misleading, such a report could lead to the issuance of criminal referrals against the involved individuals. In addition, management should be reminded that civil money penalties or other enforcement proceedings could occur as a result of chronically late or false regulatory report filing.

Banks should maintain effective manual or automated internal systems and procedures to ensure that reporting meets the appropriate regulatory requirements. Banks should develop clear, concise, and orderly workpapers to support the compilation of data. Preparation of proper workpapers provides not only a logical tie between report data and the bank’s financial records but also facilitates accurate reporting and verification. Ideally, as part of an effective internal control program, bank management should implement a procedure to verify the compilation of the data. At a minimum, an independent person or department should verify the data that have been compiled for inclusion in the report.

A bank’s internal control and audit programs for regulatory reports should be sufficient to ensure that all required reports are submitted on time and are accurate. The specific internal controls a bank employs to meet those objectives depend largely on the volume of reports, the scope of a bank’s operations, and the complexity of its accounting system.

## COMMONLY REQUIRED REGULATORY REPORTS

This section describes the regulatory reports most commonly required either to be submitted by the member bank to the Federal Reserve Bank or the Board, or to be maintained by

the member bank for review during an examination.

## Consolidated Reports of Condition and Income

Under 12 USC 324 and the Board’s Regulation H, all state member banks are required to file Consolidated Reports of Condition and Income (Call Reports) as of the last day of each calendar quarter. The specific reporting requirements, including the reporting form to be used (for example, FFIEC 031 or FFIEC 041), depend on the asset size of the bank and whether it has a foreign office. Details of the appropriate reporting guidelines, along with the specific reporting form to be filed, are found in the instructions for preparation of Reports of Condition and Income. The reporting forms and instructions can be found on the FFIEC’s website: [www.ffiec.gov](http://www.ffiec.gov).

The bank should submit completed Call Reports to the CDR no later than 30 calendar days after the report date. Any bank with more than one foreign office, other than a shell branch or international banking facility, must submit data to the CDR no later than 35 days after the report date. State member banks are *not* required to publish their Reports of Condition or Income, according to federal statute. However, a state member bank may be required to publish its Report of Condition under state law.

The Report of Condition provides consolidated, detailed financial information on assets, liabilities, capital, and off-balance-sheet activity, which permits a uniform analysis and comparison of the reporting bank’s data to that of other insured banks. The report also aggregates certain figures on loans to executive officers, directors, principal shareholders, and their related interests. The Report of Income provides information such as consolidated earnings, changes in capital accounts and the allowance for loan and lease losses, and charge-offs and recoveries.

The examiner should carefully review both reports to ensure that all pertinent data have been reported and are properly categorized in accordance with the instructions. To understand a particular bank’s Call Report, the examiner must understand the bank’s accounting methods as well as the information located in, and the relationships between, the bank’s general books and subsidiary ledgers. This understanding can be obtained only by a careful review of the

workpapers used in the preparation of these reports and their supplementary schedules.

## REPORTS REQUIRED BY THE MONETARY CONTROL ACT OF 1980 AND THE INTERNATIONAL BANKING ACT OF 1978

The Federal Reserve has established a basic deposits-reporting framework for administering Regulation D, Reserve Requirements of Depository Institutions, and for constructing, analyzing, and controlling the monetary and reserves aggregates. The framework consists of four categories of deposit reporting. Every institution is placed into one of these four categories for deposit reporting purposes.<sup>1</sup> In general, the larger the institution, the more detailed or more frequent the institution will have to report.

The first two reporting categories, characterized as “detailed reporting,” apply to those institutions that are not exempt from reserve requirements (“non-exempt” institutions). The last two reporting categories, characterized as “reduced reporting,” apply to institutions that are exempt from reserve requirements (“exempt” institutions). The reserve-requirement “exemption amount” is the amount of total reservable liabilities at each depository institution that is subject to a zero-percent reserve requirement. The exemption amount is used to make the distinction between detailed deposit reporting and reduced reporting.

- Institutions with net transaction accounts equal to or less than the exemption amount over prescribed periods are exempt from reserve requirements and are subject to reduced reporting (categories 3 and 4).
- Institutions with net transaction accounts greater than the exemption amount over prescribed periods are *not* exempt from reserve requirements and are subject to detailed reporting (categories 1 and 2).

Both measures are indexed annually; see Regulation D for the appropriate exemption and cutoff amounts.

The exemption amount and the deposit cutoff for any one calendar year are used by the

1. Depository institutions that are required to maintain reserves are defined in section 204.1(c) of Regulation D (12 CFR 204.1(c)).

Federal Reserve to determine deposit-reporting panels in July, effective for September of that year, which continues to September of the following year. All deposit reports are mandatory.

## Reporting Categories

“Non-exempt” institutions subject to detailed reporting file the Report of Transaction Accounts, Other Deposits and Vault Cash (FR 2900). Institutions file the report either weekly or quarterly, generally depending on the level of an institution’s deposits. The report is used in the calculation of reserve requirements.

“Exempt” institutions subject to “reduced reporting” file either the Annual Report of Deposits and Reservable Liabilities (FR 2910a) or no report at all, depending on their deposit levels.

Report forms and instructions can be found on the Federal Reserve Board’s website.

### Category One

Depository institutions (other than banking Edge and agreement corporations and U.S. branches and agencies of foreign banks) with net transaction accounts greater than the exemption amount and with a sum of total transaction accounts, savings deposits, and small time deposits greater than or equal to the nonexempt deposit cutoff, or with a sum of total transaction accounts, savings deposits, and small time deposits greater than or equal to the reduced reporting limit, regardless of the amount of net transaction accounts, will be required to submit the FR 2900 weekly.

Banking Edge and agreement corporations and U.S. branches and agencies of foreign banks, regardless of size, must also submit the FR 2900 weekly. They are not eligible for reporting categories 2 through 4 below.

The weekly reporting period for the FR 2900 covers the seven-day period beginning on Tuesday and ending the following Monday.

### Category Two

Depository institutions with net transaction accounts greater than the exemption amount and with a sum of total transaction accounts, savings deposits, and small time deposits less than the

nonexempt deposit cutoff are required to submit the FR 2900 once each quarter, in March, June, September, and December.

The quarterly reporting period for the FR 2900 covers the seven-day period beginning on the third Tuesday of the report month and ending the following Monday.

### *Category Three*

Depository institutions with net transaction accounts less than or equal to the exemption amount and with total deposits greater than the exemption amount but with total transaction accounts, savings deposits, and small time deposits below the reduced reporting limit are required to submit the FR 2910a. This report is filed as of June 30 each year.

### *Category Four*

Depository institutions whose net transaction accounts and total deposits are less than or equal to the exemption amount are not required to submit any Federal Reserve deposit report as long as data on the level of an institution's deposits are readily available on a condition report.

Institutions for which deposit data are not readily available on a condition report will be required to submit the FR 2910a report to determine the appropriate reporting category.

See page IV-4 and IV-5 of the Federal Reserve's *Reserve Maintenance Manual* at <http://www.frb services.org/files/regulations/pdf/rmm.pdf>.

## Annual Panel Determinations

Each year the Federal Reserve reviews the institutions in the four reporting categories, and reassignments of institutions ("panel shifts") are determined each July and become effective in September. The panel shifts reflect movements in each individual depository institution's total deposits or total reservable liabilities across the prevailing boundaries (the exemption amount and the deposit cutoff) that separate the reporting categories. Documentation is available on the Federal Reserve's procedures (including the reports, data items, and reporting periods) for

measuring an institution's total reservable liabilities and total deposits against the prevailing cutoffs for the annual panel determinations. Two special types of panel shifts are described below.

- *Voluntary shifts.* In July, the Federal Reserve informs each institution of its particular reporting requirement effective for September of that year to September of the following year. Any depository institution assigned to one particular category may elect instead to report deposits (and, if appropriate, to maintain reserves) in accordance with a higher-level category. (For example, an institution assigned to the FR 2900 quarterly reporting category may elect instead to report the FR 2900 weekly.) However, any such voluntary shifts may take place only once a year during the normal September panel shifts. Voluntary shifts to a lower-level category are not permitted.
- *Fast-growing institutions.* The Federal Reserve may require a depository institution that is experiencing above-normal growth to report on a more detailed or frequent basis before the September panel shifts.

For more detailed information, see the Federal Reserve's "Reserve Maintenance Manual."

## REPORTS REQUIRED UNDER REGULATION H AND THE SECURITIES EXCHANGE ACT OF 1934

Section 12(i) of the Securities Exchange Act of 1934 (the 1934 act), as amended by the Sarbanes-Oxley Act of 2002, vests the Board with the authority to administer and enforce certain provisions of the 1934 act and the Sarbanes-Oxley Act with respect to state member banks that have a class of securities registered under section 12(b) or 12(g) of the 1934 act (registered state member banks). In particular, the Board is charged with enforcing sections 12, 13, 14(a), 14(c), 14(d), 14(f), and 16 of the 1934 act and sections 301, 302, 303, 304, 306(a), 401(b), 404, 406, and 407 of the Sarbanes-Oxley Act<sup>2</sup> with respect to registered state member banks. Sec-

2. See 15 USC 78j-1, 78l-78n, 78p, 7241-7244(a), 7261(b), 7262, 7264, and 7265.

tion 208.36(a) of Regulation H, which implements these provisions, generally requires registered state member banks to comply with any rules, regulations, and reporting forms adopted by the Securities and Exchange Commission (SEC) under the above-listed sections of the 1934 act and the Sarbanes-Oxley Act. (See 12 CFR 208.36(a), as amended by 68 *Fed. Reg.* 4096 (January 28, 2003).) Registered state member banks, however, generally must file any forms or reports required by these rules with the Board, rather than the SEC.

If a state member bank has a class of securities registered under section 12 of the 1934 act and, thus, is a registered state member bank, the examiner should consult with the bank's management to ensure that the reports required by Regulation H are properly filed with the Board. Listed below are a few of the most common forms and reports that must be filed with the Board by a registered state member bank pursuant to Regulation H. This list, however, is not exclusive and examiners should consult Board staff or Regulation H, the 1934 act, the Sarbanes-Oxley Act, and the SEC's implementing rules if questions arise concerning the filing of reports by a registered state member bank. See the list of reporting forms and the individual reporting forms and instructions on the SEC's website: [www.sec.gov](http://www.sec.gov).

### Section 12 of the 1934 Act

Form 8-A is for the registration of certain classes of securities pursuant to sections 12(b) or 12(g) of the 1934 act for, among other things, listing on national securities exchanges. Form F-10 is the general reporting form for registration of securities pursuant to the 1933 act and sections 12(b) or 12(g) of the 1934 act for classes of securities of issuers for which no other reporting form is prescribed.

### Section 13 of the 1934 Act

Form 8-K must be filed within 4 business days after the occurrence of the earliest of one or more specified events that are required to be reported and that affect the bank or its operations, such as changes in control of registrant or an acquisition or disposition of a significant amount of assets. See the "Information to be

Included in the Report" within the report instructions. Form 10-Q is for quarterly and transition reports and must be filed within 40 days for large accelerated filers; accelerated filers; or for others, 45 days after the end of each of the first three fiscal quarters. Form 10-K is for annual and transition reports that must be filed within 60 to 90 calendar days after the end of the registrant's fiscal year.

### Section 16 of the 1934 Act

Section 16 requires the directors, officers, and principal shareholders of public companies to file reports concerning the purchase and sale of the company's equity securities. Form 3 collects the insider's initial beneficial ownership of registered companies, including banks. Form 4 collects changes in the insider's beneficial ownership. Form 5 is an annual statement of changes in beneficial ownership of securities.

### Sarbanes-Oxley Act

The Sarbanes-Oxley Act<sup>3</sup> (the act) and the SEC's implementing rules require the principal executive officer and principal financial officer of public companies to file certain certifications with the company's annual 10-K report and quarterly 10-Q reports. The certifications must, among other things, state that the officer has reviewed the report, indicate that the report (to the officer's knowledge) does not contain any material misstatements or omissions, and contain certain representations concerning the company's internal controls.

The act requires the annual 10-K report of public companies to include a statement of management's responsibility for maintaining adequate internal-control structures and procedures for financial reporting and to contain an assessment of the effectiveness of these controls and procedures.<sup>4</sup> The company's external auditor must attest to, and report on, management's assessment. These reports and attestations are similar to the internal-control reports and attestations required by section 36 of the Federal Deposit Insurance Act (12 USC 1831m) for insured depository institutions with total assets of \$500 million or more.

3. See 15 USC 7241 (section 302 of the act).

4. See 15 USC 7262 (section 404 of the act).



The act<sup>5</sup> and the SEC's rules also require public companies to disclose in their periodic reports whether the company has adopted a code of ethics for its senior financial officers and whether the company's audit committee includes a "financial expert." If the company has not adopted a code of ethics or does not have a financial expert on its audit committee, the company must explain the reasons why not.

## REPORTING AND INQUIRY REQUIREMENTS FOR LOST AND STOLEN SECURITIES

Every national securities exchange member, registered securities association member, broker, dealer, municipal securities dealer, government securities broker or dealer, registered transfer agent, and registered clearing agency and its participants, as well as every member bank of the Federal Reserve System and every bank whose deposits are insured by the Federal Deposit Insurance Corporation (reporting institutions), must register with the SEC's designee, the Securities Information Center, Inc. (SIC). All lost, missing, stolen, or counterfeit securities must be reported to the SIC. Except in certain limited circumstances, each insured bank is responsible for contacting the SIC to determine if the securities coming into its possession, whether by pledge, transfer, or some other manner, have been previously reported as missing, lost, stolen, or counterfeit.

All functions within a bank that handle or process securities are subject to the *reporting* requirements. Only the transfer-agent function is exempt from the *inquiry* requirements. Accordingly, all bank departments likely to be affected, including the trust, investment, transfer-agent, custody, or dealer departments, and the lending operations as relating to collateral loans, should be familiar with the requirements set out in 17 CFR 240.17f-1. Securities exempt from the reporting requirements are—

- registered U.S. Treasury securities of the U.S. government and federal agencies thereof,
- securities that have not been assigned CUSIP numbers, and
- bond coupons

- global securities
- uncertified securities, and
- any securities issue for which there is neither a record nor beneficial owners that can obtain negotiable securities certificates.

Securities exempt from the inquiry requirements are—

- securities received directly from the issuer or its agent at issuance,
- securities received from another reporting institution or from a Federal Reserve Bank or Branch,
- securities received from a customer of the reporting institution in the name of the customer or nominee, and
- securities that are a part of a transaction of \$10,000 or less (aggregate face value for bonds or market value for stocks).

## Lost, Missing, Stolen, or Counterfeit Securities

Form X-17F-1A must be filed with the SIC within one business day after the discovery of—

- a theft or loss of any security when there is a substantial indication of criminal activity,
- a security that has been lost or missing for two business days when criminal actions are not suspected, and
- a security that is counterfeit.

The reporting form must be filed within two business days of notification of nonreceipt when delivery of securities sent by the bank—

- is made by mail or draft and payment is not received within 10 business days, and confirmation of nondelivery has been made by the receiving institution; and
- is in person and no receipt is maintained by the bank.

If securities sent by the bank, either in person or through a clearing agency, are lost in transit and the certificate numbers of the securities can be determined, the bank (delivering institution) must report the certificate numbers of the securities within two business days after notice of non-receipt or as soon as the certificate numbers of the securities can be ascertained.

5. See 15 USC 7264–7265 (sections 406 and 407 of the act).

When a shipment of retired securities certificates is in transit between any unaffiliated transfer agents, banks, brokers, dealers, or other reporting institutions, and the delivering institution fails to receive notice of receipt or non-receipt of the certificates, the delivering institution is required to act to determine the facts. When the certificates are not recovered by the delivering institution, the delivering institution must report the certificates as lost, stolen, or missing within a reasonable time period, but in any event within twenty business days from the date of shipment. The delivery of lost or missing securities to the bank must be reported within one business day after discovery and notification of certificate numbers. Securities that are considered lost or missing as a result of count or verifications must be reported no later than 10 business days after discovery or as soon as certificate numbers can be ascertained.

Copies of all reports required to be filed under 17 CFR 240.17f-1 must also be submitted to the registered transfer agent for the issue being reported and, if criminal activities are suspected, to the Federal Bureau of Investigation. Copies of filed or received Forms X-17F-1A must be maintained in an easily accessible place for three years.

## TRANSFER-AGENT ACTIVITIES

If a bank acts as a transfer agent for its own stock, the stock of its holding company, or any other equity security, it may have to register with the Board as a transfer agent pursuant to the requirements of Regulation H (section 208.31). State member bank transfer agents must comply with the SEC's rules prescribing operational and reporting requirements, which the SEC adopted pursuant to section 17A(2) of the 1934 act (15 USC 78q-1). For member banks, see 17 CFR 240.17Ac2 (1-2) and 240.17Ad-1-240.17Ad-16). (See section 208.31(b) of Regulation H.) Any entity performing transfer agent functions for a security is required to register if the security is registered on a national securities exchange and if the issuer has total assets of \$10 million and a class of equity security held on record by 500 or more persons. The registrations are public filings and are *not* confidential.

The interagency Transfer Agent Registration and Amendment Form, Form TA-1, is used by member banks and other entities to register

before becoming, and then to act as, a transfer agent. They also use the reporting form to amend registration information as necessary. The information collected includes the company name, all business addresses, and information about the registrant's proposed activities as a transfer agent.

The Federal Reserve uses the information to act upon registration applications and to aid in performing supervisory duties. The Federal Reserve forwards copies of the completed registration forms to the Securities and Exchange Commission, which maintains registration data to aid in its statutory mandate to develop rules and standards applicable to all registered transfer agents.

## Municipal Securities Dealer Activities

A state member bank, subsidiary, department, or division thereof that is a municipal securities dealer must register and file amendments with both the SEC and the Federal Reserve Board as a municipal securities dealer by filing the SEC's Form MSD, pursuant to Section 15 B(a) of the Securities Exchange Act of 1934 and the SEC's rule 15Ba2-1. A discussion of the bank's responsibilities as a municipal securities dealer, filing requirements, and other information, including examination procedures, are discussed in section 2030.1. A notice of withdrawal from registration as a municipal securities dealer pursuant to section 15B(c) must be filed with the SEC and the Board on the SEC's Form MSDW when the municipal securities dealer is a bank, or a separately identifiable department or division of a bank.

## Government Securities Broker and Dealer Activities

If a state member bank, a foreign bank, a state branch or an agency of a foreign bank, or a commercial lending company owned or controlled by a foreign bank acts as a government securities broker or dealer, it may have to file notice with the Board as a government securities broker or dealer by filing FR G-FIN, pursuant to section 15C(a)(1)(B) of the Securities and Exchange Act of 1934. This notice collects the institution's identifying information and the names and titles of its managers of government



securities activities; the notice requires the institution to state whether any person associated with the respondent's government securities activities has been involved in disciplinary proceedings related to securities sales. When such a financial institution intends to cease engaging in broker or dealer activities, it must notify its regulator by using the Notice by Financial Institutions of Termination of Activities as a Government Securities Broker or Government Securities Dealer (FR G-FINW). A discussion of the bank's responsibilities as a government securities broker or dealer, filing requirements, and other information, including examination procedures, are discussed in SR-87-37, as amended. See also SR-94-5, 93-40, 90-1, and 88-26. The Board has also developed a Summary Report of Government Securities Broker/Dealer Activities (GSB-D report).

## INTERNATIONAL ACTIVITIES

A bank must file certain reports if it is conducting or intends to conduct international activities through either foreign branches or Edge Act or agreement corporations. Listed below is a brief description of each of these reports.

### FFIEC 009—Country Exposure Report

FFIEC 009 is filed quarterly by all U.S. banks and bank holding companies that meet certain ownership criteria and that, on a fully consolidated basis, have total outstanding claims of \$30 million or more (or equivalent) on foreign residents of the U.S. Information is collected on the distribution by country of these foreign claims on foreigners held by U.S. banks and bank holding companies.

### FFIEC 009a—Country Exposure Information Report

FFIEC 009a is a quarterly supplement to the Country Exposure Report (FFIEC 009) that provides specific information about the reporting institution's exposures in particular countries of U.S. banking institutions. Part A must be filed when exposure to a single country exceeds

1 percent of the banking institution's total assets or 20 percent of that institution's capital, whichever is less. Part B provides a list of countries where exposures were between 0.75 percent and 1 percent of the respondent's assets or between 15 percent and 20 percent of capital.

### FFIEC 030/FFIEC 030S—Foreign Branch Report of Condition/Abbreviated Foreign Branch Report of Condition

These reports collect information on the structure and geographic distribution of foreign branch assets, liabilities, derivatives, and off-balance-sheet data of foreign branches of insured U.S.-chartered commercial banks. For purposes of this report, branches in Puerto Rico and other U.S. territories and possessions are considered foreign branches. Participation in the completion and submittal of the reports is mandatory.

The FFIEC 030 is filed quarterly for significant branches, with either \$2 billion or commitments to purchase foreign currencies and U.S. dollar exchange of at least \$5 billion. It is filed annually for other branches with total assets in excess of \$250 million. The Federal Reserve uses the data to plan examinations and to analyze the foreign operations of domestic banks. Growth trends can be measured by bank, by country, and by bank within country. Aggregate data are a useful source of information on bank activities.

The FFIEC 030S collects financial data items for smaller, less-complex branches. It is filed annually, as of December 31, for foreign branches that do not meet the criteria to file the FFIEC 030 but have total assets of \$50 million or more (but less than or equal to \$250 million).

### FR 2064—Recordkeeping Requirements

Effective September 1, 2001, the FR 2064 reporting form was replaced with a recordkeeping requirement and certain structure information was moved to the FR Y-10, Report of Changes in Organizational Structure. Internationally active U.S. banking organizations are still expected to maintain adequate internal records to allow examiners to review compliance with the investment provisions of Regulation K, under

the recordkeeping requirements of FR 2064 (no form is associated with this recordkeeping requirement). For each investment made under subpart A of Regulation K, records should be maintained on the type of investment (for example, equity (voting shares, nonvoting shares, partnerships, interests conferring ownership rights, participating loans)), binding commitments, capital contributions, and subordinated debt), the amount of the investment, the percentage ownership, activities conducted by the company and the legal authority for such activities, and whether the investment was made under general-consent, prior-notice, or specific-consent authority. For those investments made under general-consent authority, information also must be maintained that demonstrates compliance with the various limits set out in sections 211.8 and 211.10 of Regulation K.

Information maintained by the banking organization should be made available to examination staff during the course of on-site examinations and pursuant to other supervisory requests. The recordkeeping must be adequate to permit examiners to determine compliance. Examiners are expected to review a sample of these investments to determine the accuracy of the organization's records and to determine compliance with the regulation. (See SR-02-2.)

### FR 2314/FR 2314S—Financial Statements of Foreign Subsidiaries of U.S. Banking Organizations

The FR 2314 is reported quarterly or annually, as of the last calendar day of the quarter, based on certain threshold criteria. The FR 2314 collects selected financial information for direct or indirect foreign subsidiaries of U.S. state member banks, Edge and agreement corporations, and bank holding companies. The FR 2314 consists of a balance sheet and income statement; information on changes in equity capital, changes in the allowance for loan and lease losses, off-balance-sheet items, and loans; and a memoranda section. The FR 2314S should be filed annually as of December 31 and collects four financial data items for smaller, less complex subsidiaries.

### FR 2502q—Quarterly Report of Assets and Liabilities of Large Foreign Offices of U.S. Banks

The FR 2502q report is to be submitted by U.S. head offices of bank holding companies, commercial banks, and Edge and agreement corporations that file for their major foreign branches and large banking subsidiaries. It provides a geographic breakdown of each office's assets and liabilities. Branches of a U.S. bank with \$500 million or more in total assets and foreign banking subsidiaries with \$2 billion or more in total assets, or \$10 million in deposit liabilities, are required to file this report quarterly.

### FR 2886b—Consolidated Report of Condition and Income for Edge Act and Agreement Corporations

FR 2886b covers the operations of the reporting corporation, including any international banking facilities of the reporter. Corporations engaged in banking must submit the data at least quarterly.

### FR 2915—Report of Foreign Currency Deposits

FR 2915 collects seven-day averages of the amounts outstanding of foreign currency-denominated deposits held at U.S. offices of the depository institution, converted to U.S. dollars and included in the Report of Transaction Accounts, Other Deposits and Vault Cash (FR 2900). The report is collected with the reporting week that begins the third Tuesday of March, June, September, and December.

### FR Y-10—Report of Changes in Organizational Structure

The Y-10 is used to report, among other things, information on worldwide organizational structure of bank holding companies (BHCs), member banks, Edge and agreement corporations, and the U.S. operations of foreign banking organizations (FBOs)<sup>6</sup>. The reporting form

6. An FBO with U.S. operations that is not or ceases to be a "qualifying foreign banking organization" (QFBO) within the meaning of Regulation K, and is not otherwise treated as

includes detailed information on the structure of top-tier BHCs organized under U.S. or foreign law that are not FBOs, regardless of financial holding company (FHC) status; FBOs (both qualifying and nonqualifying) whether or not a BHC; state member banks not controlled by a BHC or FBO; Edge and agreement corporations not controlled by a BHC, FBO, or member bank; and nationally chartered banks not controlled by a BHC or FBO, but only with respect to their foreign investments. Within 30 calendar days of the event, banking organizations are required to report changes in investments as well as new activities (both foreign and domestic) on the FR Y-10 report. The reporting form includes the structure information on changes in FBOs (formerly the FR Y-10F) and the change in status of foreign branch of U.S. banking organizations (formerly the FR 2058).

The Board has placed greater importance on monitoring the level of international investments to ensure compliance with relevant banking laws and regulations, and to ensure that banking organizations do not expose themselves to undue risk. Examiners and other Federal Reserve System staff have a continuing need to monitor compliance with the Federal Reserve Act and sections 211.8–211.10 of the revised Regulation K.

Investments of less than 25 percent of the voting shares of a foreign nonbanking company are reported on the FR Y-10.<sup>7</sup> However, using the FR Y-6 (Annual Report of Bank Holding Companies) and the FR Y-7 report (Annual Report of Foreign Banking Organizations), banking organizations are required to report annually all investments, including those between 5 percent and 25 percent of voting shares.<sup>8</sup> The FR Y-6, FR Y-7, and the FR Y-10 collect information on structure and geographical information relating to foreign investments for ongoing monitoring.

a QFBO under Regulation K, should consult with Federal Reserve staff regarding the scope of its reporting obligations. In general, an FBO that is not or is not treated as a QFBO is subject to the nonbanking restrictions of the BHC Act with respect to its worldwide operations and, thus, would have to report on the FR Y-10 changes to its worldwide organizational structure.

7. Regulation K authorizes portfolio investments in less than 20 percent of the shares of a foreign company regardless of the activities engaged in by that company. Portfolio investments within the general-consent limits are required to be reported annually on the FR Y-6.

8. Investments representing less than 5 percent ownership are not required to be reported.

Examiners are expected to review investment amounts and activities during the examination process. The portion of an examination dealing with Regulation K compliance should focus on confirming investments made pursuant to the general-consent provisions to meet the restrictions on investment amount and activities in sections 211.8–211.10 of Regulation K. Investments made under the general-consent provisions of Regulation K can be sizable, and thus can pose significant risk to the banking organization. Examiners should keep in mind that the Board has the authority to rescind an organization's general-consent investment privileges for various reasons, including safety-and-soundness concerns and noncompliance with the existing requirements of Regulation K. (See SR-02-2.)

## Treasury International Capital Forms

The following reports are collected to gather information on international capital movements by U.S. banks and their Edge Act and agreement corporations, other depository institutions, international banking facilities, and bank holding companies.

- BC: Report of U.S. Dollar Claims of Depository Institutions, Bank Holding Companies/Financial Holding Companies, Brokers, and Dealers on Foreigners
- BL-1: Report of U.S. Dollar Liabilities of Depository Institutions, Bank Holding Companies/Financial Holding Companies, Brokers, and Dealers to Foreign-Residents
- BL-2: Report of Customers' U.S. Dollar Liabilities to Foreigners
- BQ-1: Report of Customers' U.S. Dollar Claims on Foreigners
- BQ-2: Part 1. Report of Foreign Currency Liabilities and Claims of Depository Institutions, Bank Holding Companies/Financial Holding Companies, Brokers and Dealers, and of Their Domestic Customers vis-à-vis Foreigners
- BQ-2: Part 2. Report of Customers' Foreign Currency Liabilities to Foreigners
- BQ-3: Report of Maturities of Selected Liabilities of Depository Institutions, Bank Holding Companies/Financial Holding Companies, Brokers, and Dealers to Foreigners

- D: Report of Holdings of, and Transactions in, Financial Derivatives Contracts
- S: Purchases and Sales of Long-Term Securities by Foreign-Residents
- SHC/SHCA: Report of U.S. Ownership of Foreign Securities, Including Selected Money Market Instruments
- SHL/SHLA: Foreign-Residents' Holdings of U.S. Securities, Including Selected Money Market Instruments

### Consolidated Foreign Currency Reports of Major Market Participants

The Treasury Foreign Currency (TFC) Report of

major market participants collects data on the foreign exchange contracts and actively manages positions of major nonbank market participants. This report is collected and processed by the Federal Reserve System, acting as fiscal agent for the Department of the Treasury. These data are designed to assess and monitor the foreign exchange developments in the spot, forward, futures, and options markets on an individual and aggregate basis. The TFC series is comprised of three reports: (1) the Weekly Consolidated Foreign Currency Report of Major Market Participants (TFC-1), (2) the Monthly Consolidated Foreign Currency Report of Major Market Participants (TFC-2), and (3) the Quarterly Consolidated Foreign Currency Report (TFC-3).

# Review of Regulatory Reports

## Examination Objectives

Effective date May 1996

## Section 4150.2

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1. To determine that required reports are being filed on time.
2. To determine that the contents of reports are accurate.
3. To effect corrective action when official reporting, practices, policies, or procedures are deficient.

# Review of Regulatory Reports Examination Procedures

Effective date May 1993

## Section 4150.3

1. Complete or update the Internal Control Questionnaire, if selected for implementation.
2. Determine the bank's historical record of submitting timely and accurate reports by reviewing workpapers and the Regulatory Reports Monitoring Program.
3. Instruct those examiners assigned specific departments that generate regulatory reports to:
  - a. Determine from department records what regulatory reports should have been filed because of the passage of time or the occurrence of an event.
  - b. Obtain copies of all regulatory reports filed by the department since the previous examination.
  - c. Check the reports obtained in the preceding step and the date of filing against statutory and regulatory requirements.
  - d. Instruct the bank to prepare and submit any delinquent reports.
  - e. For the most recent filing of those reports submitted on a periodic basis and all other reports submitted since the last examination, perform the following:
    - Reconcile the line items shown on the reports to the bank's general ledger, subsidiary ledgers, or daily statements.
    - Obtain the bank's workpapers applicable to each line item and reconcile individual items to the reports.
    - Determine whether other examining personnel uncovered any misstatement of assets, liabilities, income, or expense during their examination of the various departments.
    - Determine that the reports are prepared in accordance with Federal Reserve and/or other applicable instructions.
  - f. On the basis of the work performed in the preceding step, perform either of the following, as appropriate:
    - If the reports are found to be substantially correct, limit the review of the remaining periodic reports filed since the last examination to the reconciliation of financial statement account categories to general ledger control accounts.
    - If the reports are found to be substantially incorrect, extend the procedures outlined in step 3.e to the remaining periodic reports filed since the last examination for those areas where items were found to be substantially incorrect.
4. Review compliance with the missing, lost, counterfeit, or stolen securities requirements of 17 CFR 240.17f-1 by:
  - a. Discussing with appropriate officers and personnel the procedures in effect regarding the filing of Form X-17F-1A (Missing, Lost, Stolen, or Counterfeit Securities Report).
  - b. Discussing with the appropriate persons the procedures in effect regarding compliance with the inquiry requirements.
  - c. Substantiating Internal Control questions 6 through 15, as appropriate.
5. Prepare comments in appropriate report form and discuss with management:
  - a. Violations of law or regulations.
  - b. Inaccurate reports, and, if applicable, the need for amended reports. If amended reports are considered appropriate, consult with Reserve Bank supervisory personnel before requesting the bank to refile the report(s).
  - c. Material differences in the annual report of the state member bank whose securities are subject to registration pursuant to the Securities Exchange Act of 1934. (State law governs the furnishing of annual reports to stockholders for banks with less than 500 shareholders.)
  - d. Recommended corrective action when policies, practices, or procedures are deficient or when reports have been filed incorrectly, late, or not at all.

The comments must include, if applicable, the name(s) and the "as of" date(s) of amended report(s); and the date of filing, amount of, and explanation of any material difference existing in either the numerical items or narrative statements in the annual report.
6. Update the workpapers with any information that will facilitate future examinations.

# Review of Regulatory Reports Internal Control Questionnaire

Effective date May 1993

## Section 4150.4

Review the bank's internal controls, policies, practices, and procedures for regulatory reports. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

1. Do requests for all regulatory reports come to one individual or department?
2. Does that individual or department have the authority to request that required information be prepared by the applicable banking department?
3. To ensure that all regulatory reports are submitted on a timely basis and are accurate, determine the following:
  - a. If completion of the report requires information from several departments:
    - Is a written memorandum sent to the various departments requesting the information?
    - Is the memorandum addressed to a department head?
    - Does the memorandum have a due date?
    - Are procedures in effect to send second requests if the memorandum is not returned by its original due date?
    - Does completion of the memorandum require two signatures, that of the person gathering the information and that of the person's superior who is held responsible for its accuracy?
  - b. If completion of the report requires information from one department, is there separation of duties to ensure that the raw data to complete the report is compiled by one person and verified by another person, prior to submission?
4. After the report is prepared, but prior to its submission, is it checked by:
  - a. The supervisor of the department preparing the report, who takes personal responsibility for its accuracy and submission on a timely basis?
  - b. Bank personnel who have no part in the report's preparation?
5. Do report workpapers leave a clear audit trail from the raw data to the finished report and are they readily available for inspection?

Review the bank's system for compliance with the reporting and inquiry requirements of the lost and stolen securities provisions of 17 CFR 240.17f-1.
6. Has the bank registered as a direct or indirect inquirer with the Securities Information Center, Inc.?
7. Are reports submitted within one business day of discovery when:
  - a. Theft or loss of a security is believed to have occurred through criminal activity?
  - b. A security has been missing or lost for two business days, except in certain cases?
  - c. A security is counterfeit?
8. Are reports submitted by the bank, as a delivering institution, within two business days of notification of nonreceipt when:
  - a. Delivery is in person and no receipt is maintained by the bank?
  - b. Delivery of securities is made by mail or via draft, and payment is not received within 10 business days and confirmation of nondelivery has been made by the receiving institution?
  - c. Securities are lost in transit and the certificate number(s) can be determined?
9. Are reports submitted by the bank, as a receiving institution, within one business day of discovery and notification of the certificate number(s) when:
  - a. Securities are delivered through a clearing agency and the delivering institution has supplied the certificate numbers within the required two business days after request?
  - b. Securities are delivered over the window and the delivering institution has a receipt and supplies the certificate number(s) within the required two business days after request?
10. Are securities that are considered to be lost or missing as a result of counts or verifications reported no later than ten business days after discovery or as soon after as the certificate number(s) can be ascertained?
11. Are copies of those reports submitted to the registered transfer agent for the issue and, in

the case of suspected criminal activity, the Federal Bureau of Investigation?

12. Are all recoveries of securities reported within one business day of recovery or finding? (Note: Only the institution that initially reported the security as missing can make a recovery report.)
13. Are inquiries made when the bank takes in any security that is not:
  - a. Received directly from the issuer or issuing agent at issuance?
  - b. Received from another reporting institution or Federal Reserve bank in its capacity as fiscal agent?
  - c. Received from a bank customer and is registered in the name of the customer or its nominee?
14. Are all reports made on Form X-17F-1A or facsimile?

15. Are copies of Form X-17F-1A and subsequent confirmations and other information received maintained for three years in an easily accessible location?

## CONCLUSION

16. Does the foregoing information provide an adequate basis for evaluating internal controls in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
17. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?



# Sale of Uninsured Nondeposit Debt Obligations on Bank Premises

Effective date May 1996

Section 4160.1

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## INTRODUCTION

State member banks have, at times, engaged in issuing nondeposit debt securities on their own behalf or assisted in the sale of these instruments (for example, commercial paper or other short-term or long-term debt securities, such as thrift notes and subordinated debentures) on behalf of their parent bank holding companies or other affiliates. It is important to ensure that these securities are not issued, marketed, or sold in a manner that could give the purchaser the impression that the obligations are federally insured deposits. Consequently, state member banks and their subsidiaries that have issued or plan to issue nondeposit debt securities should not market or sell these instruments in any public area of the bank where retail deposits are accepted, including any lobby area of the bank.

## PROCEDURES

This policy is not intended to prevent banks from selling their uninsured debt instruments in a manner that is consistent with sound and prudent banking practices. These instruments generally may be sold to investors in various ways away from the retail deposit-taking and general lobby areas of the bank. In this regard, personnel not regularly involved in deposit-taking activities or in opening new deposit accounts may make prospective investors in the community aware of uninsured debt obligations outside of the retail deposit-taking and general lobby areas. Also, these instruments may generally be sold by an employee or officer segregated from the retail deposit-taking and general lobby areas of the bank, even if the employee or officer occasionally accepts deposits or opens an account (but not as a part of his or her regular duties), so long as the arrangement is not structured in a way that misleads the purchaser or is otherwise contrary to supervisory guidelines.

Further, state member banks involved in this activity should establish procedures to ensure

that potential purchasers understand that the debt security is not federally insured or guaranteed. Specifically, the debt security should boldly state on its face that it is not insured by the Federal Deposit Insurance Corporation. In addition, this information should be verbally stated to the purchaser, and, in cases where purchasers do not take physical possession of the obligation, the purchaser should be provided with printed advice that conveys this information.

## SUPERVISORY GUIDANCE

As noted, a state member bank may also become involved in the sale of uninsured debt obligations of its parent bank holding company or a nonbank affiliate. It is a longstanding policy of the Federal Reserve that debt obligations of a bank holding company or a nonbank affiliate not be issued, marketed, or sold in a way that conveys the misimpression or misunderstanding that these instruments are either (1) federally insured deposits or (2) obligations of or guaranteed by the subsidiary bank. The purchase of these holding company obligations by retail depositors of the subsidiary bank can, in the event of default, result in losses to individuals who believed that they had acquired federally insured or guaranteed instruments. In addition to the problems created for these individuals, this situation could impair public confidence in the bank and lead to unexpected withdrawals or liquidity pressures.

If a state member bank intends to market or sell or to allow its parent holding company or a nonbank affiliate to market or sell uninsured nondeposit debt obligations on bank premises, the bank should establish internal controls to ensure that the promotion, sale, and subsequent customer relationship resulting from the sale of these debt obligations is separated from the retail deposit-taking functions of the bank. For further information on commercial paper, see section 2030, "Bank Dealer Activities."

# Sale of Uninsured Nondeposit Debt Obligations on Bank Premises

## Examination Objectives

Effective date May 1996

Section 4160.2

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1. To determine if uninsured nondeposit debt obligations of the state member bank or an affiliate are sold on bank premises.
2. To determine if the policies, practices, procedures, and internal controls for the sale of uninsured nondeposit debt instruments are adequate.
3. To ensure that the marketing and sale of uninsured nondeposit debt instruments are not conducted in a manner that conveys the impression or suggestion that they are federally insured deposits. Additionally, holding company or affiliate instruments should not convey the impression or suggestion that they are obligations of or guaranteed by the state member bank.
4. To ensure that the marketing and sale of uninsured nondeposit debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit-taking function.
5. To initiate corrective action if policies, practices, or procedures related to the sale of uninsured nondeposit debt instruments are deficient.

# Sale of Uninsured Nondeposit Debt Obligations on Bank Premises

## Examination Procedures

Effective date September 1992

## Section 4160.3

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1. Verify that the bank does not sell uninsured nondeposit debt instruments at teller windows or other areas where retail deposits are routinely accepted, including general lobby areas surrounding teller windows and personal banking desks.
2. Assess the adequacy of disclosures and the separation of the marketing and sale of uninsured nondeposit debt obligations from the retail deposit-taking function by assuring that:
  - a. the debt instrument, advertising, and all related documents disclose prominently in bold print that the debt instrument is not insured by the Federal Deposit Insurance Corporation (bank holding company debt instruments should also state that the instrument is not an obligation of, or guaranteed by, the bank);
  - b. advertisements that promote uninsured debt obligations of the bank (or an affiliate) do not also promote insured deposits of the bank in a way that could lead to confusion;
  - c. the obligor of the uninsured debt instrument is prominently disclosed and names or logos of the bank are not used on holding company or nonbank affiliate instruments in a way that might suggest the insured bank is the obligor;
- d. adequate verbal disclosures are made during telemarketing contacts and at the time of sale (a review of employee instructions or a telemarketing script, or appropriate questions directed to an employee handling this function, could assist an examiner in assessing the adequacy of verbal disclosure);
- e. retail deposit-taking employees of the insured depository institution are not engaged in the promotion or sale of uninsured nondeposit debt instruments;
- f. information on uninsured nondeposit debt instruments is not contained in the retail deposit statements of customers or in the immediate retail deposit-taking area; and
- g. account information on holdings of uninsured nondeposit debt instruments is not included on insured deposit statements.
3. Encourage the bank to obtain a signed statement from the customer indicating that the customer understands that the uninsured debt instrument is not a deposit and is not FDIC insured.

# Retail Sales of Nondeposit Investment Products

Effective date April 2008

## Section 4170.1

Depository institutions have become increasingly involved in selling uninsured nondeposit investment products, such as mutual funds or annuities, on their premises to retail customers. In response to this development, an interagency statement on retail sales of nondeposit investment products (interagency statement) was issued on February 15, 1994, to enhance customer protection and lessen possible customer confusion that these products are insured deposits.<sup>1</sup> The interagency statement applies to all insured banks and thrifts, including state member banks and the U.S. branches and agencies of foreign banks.

The guidelines contained in the interagency statement apply to retail recommendations or sales of nondeposit investment products made by—

- employees of a depository institution,
- employees of an affiliated or unaffiliated third party occurring on the premises of the banking organization (including telephone sales, investment recommendations by employees, and sales or recommendations initiated by mail from its premises), and
- sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

Retail sales include (but are not limited to) sales to individuals by depository-institution personnel or third-party personnel conducted in or adjacent to a depository institution's lobby area. The sales of government and municipal securities made in a depository institution's dealer department located away from the lobby area are not subject to the interagency statement. In addition, the interagency statement generally does not apply to fiduciary accounts administered by a depository institution. However, for fiduciary accounts where the customer directs investments, such as self-directed individual retirement accounts, the disclosures prescribed by the interagency statement (see the "Disclo-

ures and Advertising" subsection below) should be provided. Furthermore, the interagency statement applies to affiliated broker-dealers when the sales occur on the premises of the depository institution. The interagency statement also applies to sales activities of an affiliated broker-dealer resulting from a referral of retail customers by the depository institution.

The Rules of Fair Practice of the Financial Industry Regulatory Authority govern sales of securities by its member broker-dealers. In addition, the federal securities laws prohibit materially misleading or inaccurate representations in connection with the offer or sale of securities and require that sales of registered securities be accompanied by a prospectus that complies with SEC disclosure requirements.

Examiners should determine whether the institution has adequate policies and procedures to govern the conduct of the sales activities on bank premises and, in particular, whether sales of nondeposit investment products are distinguished from the deposit-taking activities of the bank through disclosure and physical means that are designed to prevent customer confusion.

Although the interagency statement does not apply to sales of nondeposit investment products to nonretail customers, such as fiduciary customers, examiners should also apply the examination procedures prescribed in SR-94-34 ("Examination Procedures for Retail Sales of Nondeposit Investment Products," May 26, 1994) when retail customers are directed to the institution's trust department, where they may purchase nondeposit investment products by simply completing a customer agreement.

### PROGRAM MANAGEMENT

Banks must adopt policies and procedures governing nondeposit investment product retail sales programs. These policies and procedures should be in place before the commencement of the retail sale of nondeposit investment products on bank premises.

The bank's board of directors is responsible for ensuring that retail sales of nondeposit investment products comply with the interagency statement and with all applicable state and federal laws and regulations. Therefore, the

1. The interagency statement was issued to Federal Reserve Banks under cover of a supervisory letter, SR-94-11 ("Interagency Statement on Retail Sales of Nondeposit Investment Products," February 17, 1994). Additional guidance is provided in SR-95-46 ("Interpretation of Interagency Statement on Retail Sales of Nondeposit Investment Products," September 14, 1995).

board, or a designated committee of the board, should adopt written policies that address the risks and management of these sales programs. Policies and procedures should reflect the size, complexity, and volume of the institution's activities or, when applicable, the institution's arrangements with any third parties selling these products on bank premises. The bank's policies and procedures should be reviewed periodically by the board of directors, or its designated committee, to ensure that they are consistent with the institution's current practices, applicable laws, regulations, and guidelines.

A bank's policies and procedures for nondeposit investment products should, at a minimum, address (1) disclosure and advertising, (2) the physical separation of investment sales from deposit-taking activities, (3) compliance and audit requirements, (4) suitability concerns, and (5) other sales practices and related risks. In addition, policies and procedures should address the following areas.

## Types of Products Sold

When evaluating nondeposit investment products, management should consider what products best meet the needs of the bank's customers. Policies should outline the criteria and procedures that will be used to select and periodically review nondeposit investment products that are recommended or sold on the bank's premises. Institutions should periodically review the products offered to ensure that they meet their customers' needs.

## Use of Identical or Similar Names

Because of the possibility of customer confusion, a nondeposit investment product must not have a name that is identical to the name of the bank or its affiliates. However, a bank may sell a nondeposit investment product with a similar name as long as the sales program addresses the even greater risk that customers may regard the product as an insured deposit or other obligation of the bank. Moreover, the bank should review the issuer's disclosure documents for compliance with SEC requirements, which call for a thorough explanation of the relationship between the bank and the mutual fund.

The Federal Reserve applies a stricter rule to investment adviser activities under Regulation Y (12 CFR 225.125) when a bank holding company (as opposed to a bank) or nonbank subsidiary acts as an investment advisor to a mutual fund. In this case, the fund may not have a name that is identical to, similar to, or a variation of the name of the bank holding company.

## Permissible Use of Customer Information

Banks should adopt policies and procedures on the use of confidential customer information for any purpose in connection with the sale of nondeposit investment products. The industry guidelines permit institutions to share with third parties only limited customer information, such as the name, address, telephone number, and types of products owned. The guidelines do not permit the sharing of more confidential information, such as specific or aggregate dollar amounts of investments or net worth, without the customer's prior acknowledgment and written consent.

## Arrangements with Third Parties

A majority of all nondeposit investment products sold on bank premises are sold by representatives of third parties. Under these arrangements, the third party has access to the institution's customers, and the bank is able to make nondeposit investment products available to interested customers without having to commit the resources and personnel necessary to sell the products directly. Third parties include wholly owned subsidiaries of a bank, bank-affiliated broker-dealers (section 20 companies<sup>2</sup> or discount brokerage firms), unaffiliated broker-dealers, insurance companies, or other companies in the business of distributing nondeposit investment products on a retail basis.

Bank management should conduct a comprehensive review of an unaffiliated third party before entering into any arrangement. The review should include an assessment of the third party's

2. A nonbank subsidiary of a bank holding company that has been authorized to underwrite and deal in certain debt and equity securities that cannot be underwritten or dealt in by member banks directly.

financial status, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including its compliance with the interagency statement.

Banks should enter into written agreements with any affiliated and unaffiliated third parties that sell nondeposit investment products on bank premises. These agreements should be approved by the bank's board of directors or its designated committee. Agreements should outline the duties and responsibilities of each party; describe third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information for investment sales activities; and define the terms for use of the bank's office space, equipment, and personnel. If an arrangement includes dual employees (bank employees also utilized by a third party), the agreement must provide for written employment contracts that specify the duties of these employees and their compensation arrangements.

In addition, a third-party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the interagency statement. The agreement should authorize the institution to monitor the third party's compliance with its agreement, as well as authorize the bank and Federal Reserve examination staff to have access to third-party records considered necessary to evaluate this compliance. These records should include examination results, sales practice reviews, and related correspondence provided to the third party by securities regulatory authorities. Finally, the agreement should provide for indemnification of the institution by an unaffiliated third party for the conduct of its employees in connection with its sales activities. Notwithstanding the provisions of a third-party agreement, bank management should monitor the conduct of nondeposit investment product sales programs to ensure that sales of the products are distinct from other bank activities and are not conducted in a manner that could confuse customers about the lack of insurance coverage for these investments.

## Contingency Planning

Nondeposit investment products are subject to price fluctuations caused by changes in interest rates and stock market valuations. In the event

of a sudden, sharp drop in the market value of nondeposit investment products, institutions may experience a heavy volume of customer inquiries, complaints, and redemptions. Therefore, management should develop contingency plans to address these situations. A major element of any contingency plan should be to provide customers with access to information about their investments. Other factors to consider in contingency planning include public relations and the ability of operations staff to handle increased volumes of transactions.

## DISCLOSURES AND ADVERTISING

### Content, Form, and Timing of Disclosures

Nondeposit investment product sales programs should ensure that customers are clearly and fully informed of the nature and risks associated with these products. In addition, nondeposit investment products must be clearly differentiated from insured deposits. The interagency statement identifies the following minimum disclosures that must be made to customers when providing investment advice, making investment recommendations, or effecting nondeposit investment product transactions:

- They are not insured by the FDIC.
- They are not deposits or other obligations of the institution and are not guaranteed by the institution.
- They are subject to investment risks, including the possible loss of the principal invested.

There are limited situations in which the disclosure guidelines need not apply or where a shorter logo format may be used in lieu of the longer written disclosures.

The interagency statement disclosures do not need to be provided in the following situations:

- radio broadcasts of 30 seconds or less;
- electronic signs,<sup>3</sup> and
- signs, such as banners and posters, when they are used only as location indicators.

3. "Electronic signs" may include billboard-type signs that are electronic, time-and-temperature signs, and ticker-tape signs. Electronic signs would not include such media as television, on-line services, or ATMs.

Additionally, third-party vendors not affiliated with the depository institution need not make the interagency statement disclosures on non-deposit investment product confirmations and in account statements that may incidentally, with a valid business purpose, contain the name of the depository institution.

Shorter, logo-format disclosures may be used in visual media, such as television broadcasts, ATM screens, billboards, signs, posters, and written advertisements and promotional materials, such as brochures. The text of an acceptable logo-format disclosure would include the following statements:

- Not FDIC-Insured.
- No Bank Guarantee.
- May Lose Value.

Disclosure is the most important way of ensuring that the differences between non-deposit investment products and insured deposits are understood by retail customers. Accordingly, it is critical that the minimum disclosures be presented clearly and concisely in both oral and written communications. In this regard, the minimum disclosures should be provided—

- orally during any sales presentations (including telemarketing contacts) or when investment advice is given,
- orally and in writing before or at the time an investment account to purchase these products is opened, and
- in all advertisements and other promotional materials (discussed further below).

The minimum disclosures may be made on a customer account agreement or on a separate disclosure form. The disclosures must be conspicuous (highlighted through bolding, boxes, and/or a larger typeface). Disclosures contained directly on a customer account agreement should be located on the front of the agreement or adjacent to the customer signature block.

Banks are to obtain a written acknowledgment—on the customer account agreement or on a separate form—from a customer confirming that he or she has received and understands the minimum disclosures. For nondeposit investment product accounts established before the issuance of the interagency statement, banks should obtain a disclosure acknowledgment from the customer at the time of the customer's next purchase transaction. If an institution solicits

customers by telephone or mail, it should ensure that the customers receive the written disclosures and an acknowledgment to be signed and returned to the institution.

Customer account statements, including combined statements for linked accounts and trade confirmations that are provided by the bank or an affiliate, should contain the minimum disclosures if they display the name or logo of the bank or its affiliate. Statements that provide account information about insured deposits and nondeposit investment products should clearly segregate the information about nondeposit investment products from the information about deposits to avoid customer confusion.

## Advertising

The interagency statement provides that advertisements in all media forms that identify specific investment products must conspicuously include the minimum disclosures and must not suggest or convey any inaccurate or misleading impressions about the nature of a nondeposit investment product. Promotional material that contains information about both FDIC-insured products and nondeposit investment products should clearly segregate the information about the two product types. When promotional sales materials related to nondeposit investment products are displayed in the bank's retail areas, they should be grouped separately from material related to insured bank products.

Telemarketing scripts should be reviewed to determine whether bank personnel are inquiring about customer investment objectives, offering investment advice, or identifying particular investment products or types of products. In these cases, the scripts must contain the minimum disclosures, and bank personnel relying on the scripts must be formally authorized to sell nondeposit investment products by their employers. Further, these personnel must have training that is the substantive equivalent of that required for personnel qualified to sell securities as registered representatives (see the "Training" subsection below).

## Additional Disclosures

A bank should apprise customers of certain material relationships. For example, a customer

should be informed by sales personnel orally and in writing before the sale about any advisory relationship existing between the bank (or an affiliate) and a mutual fund whose shares are being sold by the institution. Similarly, fees, penalties, or surrender charges associated with a nondeposit investment product should be disclosed by sales personnel orally and in writing before or at the time the customer purchases the product. The SEC requires written disclosure of this information in the investment product's prospectus.

If sales activities include any written or oral representations concerning insurance coverage by any entity other than the FDIC (for example, SIPC insurance of broker-dealer accounts, a state insurance fund, or a private insurance company), then clear and accurate explanations of the coverage must also be provided to customers at that time to minimize possible confusion with FDIC insurance. These disclosures should not suggest that other forms of insurance are the substantive equivalent to FDIC deposit insurance.

## SETTING AND CIRCUMSTANCES

### Physical Separation from Deposit Activities

Selling or recommending nondeposit investment products on bank premises may give the impression that the products are FDIC-insured or are obligations of the bank. To minimize customer confusion with deposit products, nondeposit investment product sales activities should be conducted in a location that is physically distinct from the areas where retail deposits are taken. Bank employees located at teller windows may not provide investment advice, recommend investment products, or accept orders (even unsolicited orders) for nondeposit investment products.

To decide whether nondeposit investment product sales activities are sufficiently separate from deposit activities, the particular circumstances of each bank need to be evaluated. FDIC insurance signs and insured deposit-related promotional material should be removed from the investment product sales area and replaced with appropriate signs indicating that the area is used for the sale of investment products. Signs referring to specific investments should prominently contain the minimum disclosures. In the limited

situation where physical constraints prevent nondeposit investment product sales activities from being conducted in a distinct and separate area, the institution has a heightened responsibility to ensure that appropriate measures are taken to minimize customer confusion.

In the case of banks that are affiliated with section 20 companies that sell retail investment products directly to bank customers, the requirement for separation of deposit-taking facilities from the securities operations of the section 20 company is absolute under the relevant firewall conditions imposed on these companies by the Board. Accordingly, retail sales activities conducted by a section 20 company must be in a separate office which, at a minimum, is set off from deposit-taking activities by partitions and identified by signs with the name of the section 20 company. Further, section 20 company employees may not be dual employees of the bank. Business cards for designated sales personnel should clearly indicate that they sell nondeposit investment products or, if applicable, are employed by a broker-dealer.

The interagency statement was intended generally to cover sales made to retail customers in the bank lobby. However, some institutions may have an arrangement whereby retail customers purchase nondeposit investment products at a location of the institution that is generally confined to institutional services (for example, corporate money desk). In these cases, the bank should still ensure that retail customers receive the minimum disclosures to minimize any possible customer confusion with nondeposit investment products and insured deposits.

### Hybrid Instruments and Accounts

When an institution offers accounts that link traditional bank deposits with nondeposit investment products, such as a cash-management account,<sup>4</sup> the accounts should be opened in the investment sales area by trained personnel. In light of the hybrid characteristics of these products, the opportunity for customer confusion is amplified, and the institution should take special care during the account-opening process to ensure that a customer is accurately informed that

4. A hybrid account may incorporate deposit and brokerage services, credit/debit card features, and automated sweep arrangements.



- funds deposited into a sweep account will only be FDIC-insured until they are swept into a nondeposit investment product account and
- customer account statements may disclose balances for both insured and nondeposit product accounts.

## DESIGNATION, TRAINING, AND SUPERVISION OF PERSONNEL

### Hiring and Training of Sales Personnel

Banks hiring sales personnel for nondeposit investment product programs should investigate the backgrounds of prospective employees. When a candidate for employment has previous investment industry experience, the bank should check whether the individual has been the subject of any disciplinary actions by securities, state, or other regulators.

Unregistered bank sales personnel should receive training that is the substantive equivalent of that provided to personnel qualified to sell securities as registered representatives. Training should cover the areas of product knowledge, trading practices, regulatory requirements and restrictions, and customer-protection issues. In addition, training programs should cover the bank's policies and procedures for sales of nondeposit investment products and should be conducted continually to ensure that staff are familiar with new products and compliance issues.

For those bank employees whose sales activities are limited to mutual funds or variable annuities, the equivalent training is that ordinarily needed to pass NASD's series 6 limited representative examination, which typically involves approximately 30 to 60 hours of preparation, including about 20 hours of classroom training. Bank employees who are authorized to sell additional investment products and securities should receive training that is appropriate to pass the NYSE's series 7 general securities representative examination, which typically involves 160 to 250 hours of study, including at least 40 hours of classroom training.

The training of third-party or dual employees is the responsibility of the third party. When entering into an agreement with a third party, bank management should be satisfied that the third party is able to train third-party and dual

employees with respect to compliance with the minimum disclosures and other requirements of the interagency statement. Copies of third-party training and compliance materials should be obtained and reviewed by the bank to monitor the third party's performance regarding its training obligations.

### Training of Bank Personnel Who Make Referrals

Bank employees, such as tellers and platform personnel, who are not authorized to provide investment advice, make investment recommendations, or sell nondeposit investment products, but who may refer customers to authorized nondeposit investment products sales personnel, should receive training about the strict limitations on their activities. In general, bank personnel who are not authorized to sell nondeposit investment products are not permitted to discuss general or specific investment products, prequalify prospective customers as to financial status and investment history and objectives, open new accounts, or take orders on a solicited or unsolicited basis. These personnel may contact customers for the purposes of—

- determining whether the customer wishes to receive investment information
- inquiring whether the customer wishes to discuss investments with an authorized sales representative, and
- arranging appointments to meet with authorized bank sales personnel or third-party broker-dealer registered sales personnel.

The minimum disclosure guidelines do not apply to referrals made by personnel not authorized to sell nondeposit investment products if the referral does not provide investment advice, identify specific investment products, or make investment recommendations.

### Supervision of Personnel

Bank policies and procedures should designate, by title or name, the individuals responsible for supervising nondeposit investment product sales activities, as well as the referral activities of bank employees not authorized to sell these products. Personnel responsible for managing

the sales programs for these products should have supervisory experience and training equivalent to that required of a general securities principal, as required by the NASD for broker-dealers. Supervisory personnel should be responsible for the bank's compliance with policies and procedures on nondeposit investment products, applicable laws and regulations, and the interagency statement. When sales of these products are conducted by a third party, supervisory personnel should be responsible for monitoring compliance with the agreement between the bank and the third party, as well as compliance with the interagency statement, particularly the guideline calling for nondeposit investment product sales to be separate and distinct from the deposit activities of the bank.

## SUITABILITY AND SALES PRACTICES

### Suitability of Recommendations

Suitability refers to the matching of customer financial means and investment objectives with a suitable product. If customers are placed into unsuitable investments, the resulting loss of consumer confidence could have detrimental effects on the bank's reputation. Many first-time investors may not fully understand the risks associated with nondeposit investment products and may assume that the bank is responsible for the preservation of the principal of their investment.

Banks that sell nondeposit investment products directly to customers should develop detailed policies and procedures addressing the suitability of investment recommendations and related recordkeeping requirements. Sales personnel that recommend nondeposit investment products to customers should have reasonable grounds for believing that the recommended products are suitable for the particular customer on the basis of information he or she has provided. A reasonable effort must be made to obtain, record, and update information concerning the customer's financial profile (for example, tax status, other investments, income), investment objectives, and other information necessary to make recommendations.

In determining whether sales personnel are meeting their suitability responsibilities, examiners should review the practices for conformance with the bank's policies and procedures.

The examiner's review should include a sample of customer files to determine the extent of customer information collected, recorded, and updated (for subsequent purchases) and should determine whether investment recommendations appear unsuitable in light of this information.

Nondeposit investment product sales programs conducted by third-party broker-dealers are subject to the NASD's suitability and other sales practice rules. To avoid duplicating NASD examination efforts, examiners should rely on the NASD's most recent sales practice review of the third party, when available. If an NASD review has not been completed within the last two years, Reserve Banks should consult with Board staff to determine an appropriate examination scope for suitability compliance before proceeding further.

### Sales Practices and Customer Complaints

Banks should have policies and procedures that address undesirable practices by sales personnel, such as practices to generate additional commission income for the employee by churning or switching accounts from one product to another. Banks should have policies and procedures for handling customer complaints related to nondeposit investment products. The process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. The merits and circumstances of each complaint (including all documentation relating to the transaction) should be considered when determining the proper form of resolution. Reasonable timeframes should be established for addressing complaints.

## COMPENSATION

Incentive compensation programs specifically related to the sale of nondeposit investment products may include sales commissions, limited fees for referring prospective customers to an authorized sales representative, and nonmonetary compensation (prizes, awards, and gifts). Compensation that is paid by unaffiliated third parties (for example, mutual fund distributors) to bank staff must be approved in writing by

bank management, be consistent with the bank's written internal code of conduct for the acceptance of remuneration from third parties, and be consistent with the proscriptions of the Bank Bribery Act (18 USC 215) and the banking agencies' implementing guidelines to that act. (See SR-87-36, "Bank Bribery Act Guidelines," October 30, 1987.) Compensation policies should establish appropriate limits on the extent of compensation that may be paid to banking organization staff by unaffiliated third parties.

Incentive compensation programs must not be structured in such a way that they result in unsuitable investment recommendations or sales to customers. In addition, if sales personnel sell both deposit and nondeposit products, similar financial incentives should be in place for sales of both types of products. A compensation program that offers significantly higher remuneration for selling a specific product (such as a proprietary mutual fund) may be inappropriate if it results in unsuitable recommendations to customers. A compensation program that is intended to provide remuneration for a group of bank employees (such as a branch or department) is permissible as long as the program is based on the group's overall performance in meeting bank objectives for a broad variety of bank services and products and not on the volume of sales of nondeposit investment products.

Individual bank employees, such as tellers, may receive a one-time nominal fee of a fixed-dollar amount for referring customers to authorized sales personnel to discuss nondeposit investment products. However, the payment of the fee should not depend on whether the referral results in a transaction. Nonmonetary compensation to bank employees for referrals should be similarly structured. Auditors and compliance personnel should not participate in incentive compensation programs that are directly related to the results of nondeposit investment product sales programs.

## COMPLIANCE

Banks must develop and maintain written policies and procedures that effectively monitor and assess compliance with the interagency statement and other applicable laws and regulations and that ensure appropriate follow-up to correct identified deficiencies. Compliance programs

should be independent of sales activities with respect to scheduling, compensation, and performance evaluations. Compliance findings should periodically be reported to the bank's board of directors or a designated committee of the board as part of the institution's ongoing oversight of nondeposit investment product activities. Compliance personnel should have appropriate training and experience with nondeposit investment product sales programs, applicable laws and regulations, and the interagency statement.

Banks should institute compliance programs for nondeposit investment products that are similar to those of securities broker-dealers. This includes a review of new accounts and a periodic review of transactions in existing accounts to identify any potentially abusive practices, such as unsuitable recommendations, churning, or switching. Compliance personnel should also oversee the prompt resolution of customer complaints and review complaint logs for questionable sales practices. Management-information-system reports on early redemptions and sales patterns for specific sales representatives and products should also be used by compliance personnel to identify any potentially abusive practices. In addition, the referral activities of bank personnel should be reviewed to ensure that they conform to the guidelines in the interagency statement.

When nondeposit investment products are sold by third parties on bank premises, the bank's compliance program should provide for oversight of the third party's compliance with its agreement with the bank, including its conformance to the disclosure and separate-facilities guidelines of the interagency statement. The results of this oversight should be reported to the board of directors or a designated committee of the board. Management should obtain the third party's commitment to promptly correct identified problems. Proper follow-up by the bank's compliance personnel should verify the third party's corrective actions.

## AUDITS

Audit personnel should be responsible for assessing the effectiveness of the institution's compliance function and overall management of the nondeposit investment product sales program. The scope and frequency of audit reviews of nondeposit investment product activities will depend on the complexity and sales volume of a

sales program and on whether there are any indications of potential or actual problems. Audits should cover all of the issues discussed in the interagency statement. Internal audit staff should be familiar with nondeposit investment products and receive ongoing training. Findings should be reported to the board of directors or to

a designated committee of the board, and proper follow-up should be performed. Audit activities with respect to third parties should include a review of their compliance function and the effectiveness of the bank's oversight of the third party's activities.

# Retail Sales of Nondeposit Investment Products

## Examination Objectives

Effective date May 1996

## Section 4170.2

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1. To determine that the banking organization has taken appropriate measures to ensure that retail customers clearly understand the differences between insured deposits and non-deposit investment products and that they receive the minimum disclosures both orally during sales presentations (including telemarketing) and in writing.
2. To assess the adequacy of the institution's policies and procedures, sales practices, and oversight by management and the board of directors to ensure an operating environment that fosters customer protection in all facets of the sales program.
3. To ensure that the sales program is conducted in a safe and sound manner that is in compliance with the interagency statement, Federal Reserve guidelines, regulations, and applicable laws.
4. To assess the effectiveness of the institution's compliance and audit programs for non-deposit investment product operations.
5. To obtain commitments for corrective action when policies, procedures, practices, or management oversight is deficient or when the institution has failed to comply with the interagency statement or applicable laws and regulations.

# Retail Sales of Nondeposit Investment Products

## Examination Procedures

Effective date September 1992

## Section 4170.3

1. Verify through the minutes of the board of directors that the directors have approved the sale of uninsured annuities, reviewed, and approved the choice of an underwriter in the past year.
  2. Determine if the bank adequately evaluates the underwriter's financial condition at least annually and regularly reviews the credit ratings assigned to the underwriter by at least two independent agencies evaluating annuity underwriters. (Banks engaged in the sale of annuities are expected to sell only products of financially secure underwriters and to make current ratings of the underwriter available to an investor when purchasing an uninsured annuity.)
  3. Verify that the bank does not sell uninsured annuities at teller windows or other areas where retail deposits are routinely accepted.
  4. Assess the adequacy of disclosures and the separation of the marketing and sale of uninsured annuities from the retail deposit-taking function by ensuring that—
    - a. the contract, advertising, and all related documents disclose prominently in bold print that the annuities are not deposits or obligations of an insured depository institution and are not insured by the Federal Deposit Insurance Corporation;
    - b. advertisements do not contain words, such as "deposit," "CD," etc., that could lead an investor to believe an annuity is an insured deposit instrument;
    - c. the obligor of the annuity contract is prominently disclosed and names or logos of the insured bank are not used in a way that might suggest the insured bank is the obligor;
    - d. adequate verbal disclosures are made during telemarketing contacts and at the time of sale;
    - e. retail deposit-taking employees of the insured depository institution are not engaged in the promotion or sale of uninsured annuities;
  - f. information on uninsured annuities is not contained in retail deposit statements of customers (either as advertising on deposit statements or as "junk mail" stuffers included with deposit statements) or in the immediate retail deposit-taking area;
  - g. account information on annuities owned by customers is not included on insured deposit statements; and
  - h. officer or employee remuneration associated with selling annuities is limited to reasonable levels in relation to the individual's salary. (As a guideline in reviewing remuneration, see the Board's policy statement on disposition of credit life insurance, as discussed in the Consumer Credit, Examination Procedures, section of this manual.)
5. If the bank allows a third-party entity to market annuities on depository-institution premises, assess the adequacy of disclosures and the separation of the marketing and sale of uninsured annuities from the retail deposit-taking function by determining that—
    - a. the bank has ensured that the third-party company is properly registered or licensed to conduct this activity,
    - b. bank personnel are not involved in sales activities conducted by the third party,
    - c. desks or offices used to market or sell annuities are separate and distinctly identified as being used by an outside party, and
    - d. bank personnel do not normally use desks or offices used by a third party for annuities sales.
  6. Encourage the bank to obtain a signed statement from the customer indicating that the customer understands that the annuity is not a deposit or any other obligation of the bank, that the bank is only acting as an agent for the insurance company (underwriter), and that the annuity is not FDIC-insured.

### INTERAGENCY POLICY ON BANKS AND THRIFTS PROVIDING FINANCIAL SUPPORT TO FUNDS ADVISED BY THE BANKING ORGANIZATION OR ITS AFFILIATES

On January 5, 2004, the federal banking agencies<sup>1</sup> (the agencies) issued an interagency policy statement to alert banking organizations, including their boards of directors and senior management, of the safety-and-soundness implications of, and the legal impediments to, a bank providing financial support to investment funds<sup>2</sup> advised by the bank, its subsidiaries, or affiliates (affiliated investment funds). A banking organization's investment advisory services can pose material risks to the bank's liquidity, earnings, capital, and reputation and can harm investors, if the associated risks are not effectively controlled. (See SR-04-1.)

Banks are under no statutory requirement to provide financial support to the funds they advise; however, circumstances may motivate banks to do so for reasons of reputation risk and liability mitigation. This type of support by banking organizations to funds they advise has included credit extensions, cash infusions, asset purchases, and the acquisition of fund shares. In very limited circumstances, certain arrangements between banks and the funds they advise have been expressly determined to be legally permissible and safe and sound when properly conducted and managed. However, the agencies are concerned about other occasions when emergency liquidity needs may prompt banks to support their advised funds in ways that raise prudential and legal concerns. Federal laws and regulations place significant restrictions on transactions between banks and their advised funds. In particular, sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W (12 CFR 223) place quantitative limits and

collateral and market-terms requirements on many transactions between a bank and certain of its advised funds.

#### Interagency Policy

To avoid engaging in unsafe and unsound banking practices, banks should adopt appropriate policies and procedures governing routine or emergency transactions with bank-advised investment funds. Such policies and procedures should be designed to ensure that the bank will *not* (1) inappropriately place its resources and reputation at risk for the benefit of the funds' investors and creditors; (2) violate the limits and requirements contained in sections 23A and 23B of the Federal Reserve Act and Regulation W, other applicable legal requirements, or any special supervisory condition imposed by the agencies; or (3) create an expectation that the bank will prop up the advised fund. Further, the agencies expect banking organizations to maintain appropriate controls over investment advisory activities that include:

- Establishing alternative sources of emergency support from the parent holding company, nonbank affiliates, or external third parties prior to seeking support from the bank.
- Instituting effective policies and procedures for identifying potential circumstances triggering the need for financial support and the process for obtaining such support. In the limited instances that the bank provides financial support, the bank's procedures should include an oversight process that requires formal approval from the bank's board of directors, or an appropriate board-designated committee, independent of the investment advisory function. The bank's audit committee also should review the transaction to ensure that appropriate policies and procedures were followed.
- Implementing an effective risk-management system for controlling and monitoring risks posed to the bank by the organization's investment advisory activities. Risk controls should include establishing appropriate risk limits, liquidity planning, performance measurement systems, stress testing, compliance reviews, and management reporting to mitigate the need for significant bank support.

1. The Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS).

2. Bank-advised investment funds include mutual funds, alternative strategy funds, collective investment funds, and other funds where the bank, its subsidiaries, or affiliates is the investment adviser and receives a fee for its investment advice.

- Implementing policies and procedures that ensure that the bank is in compliance with existing disclosure and advertising requirements to clearly differentiate the investments in advised funds from obligations of the bank or insured deposits.
- Ensuring proper regulatory reporting of contingent liabilities arising out of its investment advisory activities in the banking organization's published financial statements in accordance with FAS 5, and fiduciary settlements, surcharges, and other losses arising out of its investment advisory activities in accordance with the instructions for completing call report Schedule RC-T (Fiduciary and Related Services).

### Notification of a Banking Organization's Primary Federal Regulator

Because of the potential risks posed by the provision of financial support to advised funds, bank management should notify and consult with its appropriate federal banking agency prior to (or immediately after, in the event of an emergency) the bank providing material financial support to its advised funds. The appropriate federal banking agency will closely scrutinize the circumstances surrounding the transaction and will address situations that raise supervisory concerns.



# Investment-Funds Support

## Examination Objectives

Effective date May 2004

## Section 4180.2

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1. To determine if the bank provides support to an advised fund and, if so, the type of support that is being provided.
2. If the bank is providing support to an advised fund, to ascertain whether the type of support raises prudential (safety-and-soundness) or legal concerns, such as noncompliance with sections 23A and 23B of the Federal Reserve Act, and with Regulation W.
3. To determine whether the bank has adopted appropriate policies and procedures governing routine or emergency transactions with funds that it advises.
4. To find out if the bank has established appropriate controls over investment advisory activities.
5. If a bank has provided material financial support to an advised fund, to determine if the bank notified its primary federal regulator before engaging in the activity.

# Investment-Funds Support Examination Procedures

Effective date May 2004

## Section 4180.3

1. Determine if the bank has inappropriately placed its resources at risk for the benefit of an affiliated investment fund's investors and creditors.
2. Ascertain whether the bank's advisory services to investment funds pose material risks to the bank's liquidity, earnings, and capital.
3. Determine if the bank provides support to an investment fund and if that support violates the limits and requirements of sections 23A and 23B of the Federal Reserve Act, and Regulation W; other applicable legal requirements; or any special supervisory condition imposed by the bank's primary federal supervisory agency.
4. Find out if the bank has given any form of assurances or expectations that it will provide financial or other support to an advised fund.
5. Ascertain whether the bank has established appropriate controls over investment advisory activities, such as:
  - a. Establishing alternative sources of emergency support that can be made available to an advised fund from the parent holding company, nonbank affiliates, or external third parties before the fund seeks financial support from the bank.
  - b. Instituting effective policies and procedures to—
    - identify potential circumstances that would trigger the need for financial support by an affiliated fund, and establish the process for obtaining that support;
    - ensure that the bank is in compliance with existing disclosure and advertising requirements that clearly differentiate the investments in advised funds from the bank's other obligations or federally insured deposits; and
    - avoid unsafe and unsound banking practices by initiating procedures that govern routine or emergency transactions with bank-advised investment funds.
6. Determine if the bank notified and consulted with the appropriate supervising Federal Reserve Bank before (or, in an emergency, immediately after) providing financial support to an affiliated investment fund.
  - c. Implementing an effective risk-management system for controlling and monitoring risks posed to the bank by its investment advisory activities.
  - d. Ensuring the bank's proper reporting, in its financial statements, of contingent liabilities that arise out of its investment advisory activities (in accordance with FAS 5 and the bank call report instructions for completing Schedule RC-T for fiduciary activities).

# Investment-Funds Support Internal Control Questionnaire

Effective date May 2004

## Section 4180.4

Review the bank's internal controls, policies, practices, and procedures concerning investment funds that it advises. When performing that task, conduct examination reviews and procedures to answer the following questions:

1. Has the bank—
  - a. inappropriately placed its financial resources or reputation at risk for the benefit of affiliated investment funds' investors and creditors?
  - b. violated the limits and requirements in sections 23A and 23B of the Federal Reserve Act and in Regulation W, with regard to its transactions with advised investment funds?
  - c. created any expectation that the bank will prop up an advised fund?
2. Do the bank's advisory services pose material risks to its liquidity, earnings, and capital?
3. Does the bank encourage its advised investment funds to establish alternative sources of financial support so that the funds can avoid seeking support from the bank itself?
4. Has the bank provided support to the funds it advises, such as with extensions of credit, cash infusions, asset purchases, acquisition of fund shares, or any other type of financial support?
5. Has the bank implemented and maintained an effective risk-management system for controlling and monitoring the risks posed to the bank by its investment advisory activities?
6. Did the bank's board of directors adopt appropriate policies and procedures to avoid engaging in unsafe and unsound banking practices with respect to routine or emergency transactions with bank-advised investment funds?
7. Has the bank's management properly reported contingencies arising out of its investment advisory activities, in accordance with FAS 5, and also any fiduciary settlements, surcharges, and other losses arising out of its investment advisory activities, in accordance with the instructions of the bank call report schedule RC-T (Fiduciary and Related Services)?
8. Has the bank's management notified and consulted with its appropriate supervising Federal Reserve Bank before (or, in an emergency, immediately after) providing material financial support to advised funds?

Fiduciary activities and other related services generally include traditional trust services, such as personal trust, corporate trust, and transfer-agent services and employee benefit account products and services, as well as custody and securities-lending services, clearing and settlement, private banking, asset management, and investment advisory activities. (See SR-01-5.)

Pursuant to 12 USC 24 (seventh), 92a, and 93a, the Office of the Comptroller of the Currency (OCC) has established standards (the OCC rules for fiduciary activities of national banks). These rules are typically considered the industry standard for fiduciary activities of all financial institutions operating in the United States. (See 12 CFR 9.) When considering whether a state member bank has adhered to industry standards for fiduciary activities, Federal Reserve System (FRS) examiners can refer to the guidance set forth in the OCC rules and FRS and OCC examination manuals, as well as the examination materials issued by other U.S. financial institution regulatory agencies. With respect to a state member bank subsidiary, the appropriate bank, thrift, or functional regulator has the primary supervisory responsibility for evaluating risks, hedging, and risk management at the legal-entity level for the entity that the regulator supervises. (See SR-00-13.) Examiners should seek to use the examination findings of the functional regulator.

A risk-focused fiduciary examination concentrates on understanding and evaluating risk and assessing the internal controls the state member bank has employed to manage risk. The program encompasses continuous monitoring; targeted reviews of fiduciary activities; preparation of supervisory risk profiles and assessments; and the development of supervisory plans, which are integrated into the preplanning of an examination. Conclusions are used to develop an overall safety-and-soundness evaluation of the state member bank's fiduciary activities. (See SR-96-10.)

The Federal Reserve System's fiduciary-examination program reviews and assesses the risk-management practices and related aspects of a state member bank's fiduciary activities. This approach results in (1) the use of a more diversified examiner population, including those with capital-markets, information systems, and safety-and-soundness experience; (2) an emphasis on assessing the individual organization's

unique risk profile; and (3) reviews of risk identification, measurement, monitoring, and control. Examiners should use the state member bank's control disciplines (internal audit, risk management, and compliance program) whenever possible.

Examiners have access to a broad variety of FRS supervisory information and analytical support tools to evaluate the fiduciary activities of financial institutions. The Uniform Bank Performance Report (UBPR) can assist examiners in evaluating a state member bank's fiduciary business lines or activities relative to its peers. (See the UBPR, pages Trust 1 and Trust 1A.) Beginning with the December 2002 release, "Section II: Technical Information" of the *UBPR User's Guide* (available online at [www.ffiec.gov/ubprguide.htm](http://www.ffiec.gov/ubprguide.htm)) discusses the availability of the Total Fiduciary Assets within a fiduciary group number (peer group). (See page II-3.) "Total Fiduciary Assets" are the totals of managed and nonmanaged fiduciary assets for FDIC-insured commercial and savings banks, as reported on Schedule RC-T of the call report.

## COMPLEX FIDUCIARY ORGANIZATIONS

SR-01-5 explains that complex fiduciary organizations are those banking organizations that conduct significant or complex fiduciary activities. This includes large complex banking organizations (LCBOs), other large or regional institutions for which fiduciary activities represent a significant portion of their business, and clearing agencies registered with the Securities and Exchange Commission (SEC) for which the Federal Reserve is the primary supervisor. The fiduciary-examination frequency should be determined on the basis of the impact that fiduciary activities have on the organization's risk profile. At a minimum, all material fiduciary business lines should be subject to examination over a two-year period or examination cycle as part of the continuous supervision process, with higher-risk areas generally reviewed annually.

Composite Uniform Interagency Trust Rating System (UITRS) ratings and transfer-agent ratings reflecting the overall condition of the fiduciary function at each institution, and any component ratings considered relevant, should be

assigned or updated in a timely manner on the basis of the results of examinations, targeted reviews, or other assessments of fiduciary activities. UITRS ratings do not need to be assigned for each targeted business-line review. However, at a minimum, composite UITRS and transfer-agent ratings should be updated annually, and any material findings related to these areas should be included in the annual summary supervisory report. Any significant concerns should be reflected in the safety-and-soundness examination ratings. Fiduciary risks and fiduciary-risk management assessments should also be reflected in the relevant risk-assessment and risk-management ratings for the banking organization, as necessary.

## OTHER INSTITUTIONS OFFERING FIDUCIARY AND TRANSFER-AGENT SERVICES

The frequency of fiduciary and transfer-agent examinations for other institutions, generally smaller state-chartered Federal Reserve member banks and trust companies with noncomplex operations, should be determined on the basis of the significance of their fiduciary and transfer-agent activities and an assessment of the level of risk the activities present to the institution. This scheduling guidance also applies to initial examinations of new institutions and to those institutions subject to Federal Reserve supervision as a result of a charter conversion.

At a minimum, fiduciary activities should be reviewed no less frequently than during every other routine safety-and-soundness examination. Examinations governed by alternating examination programs with state banking authorities may continue to be performed in accordance with those arrangements or as necessary to incorporate the provisions of SR-01-5. Examinations of fiduciary activities at noncomplex limited-purpose trust companies and other fiduciary institutions subject to supervision by the Federal Reserve that do not receive routine safety-and-soundness examinations should be conducted no less frequently than every two years.

Composite UITRS and transfer-agent examination ratings reflecting the overall condition of the function, and any component ratings considered relevant, should be assigned or updated at the completion of the examination or assess-

ment. Material examination findings should be integrated into the overall examination report for the institution, which should clearly indicate the significance of any findings to the safety and soundness of the institution and the impact of the findings on any relevant risk assessments and risk-management ratings.

## ORGANIZATIONS WITH SUPERVISORY CONCERNS

Organizations whose fiduciary activities have raised supervisory concerns should be subject to an additional level of supervisory attention on the basis of the severity of those supervisory concerns. Generally, this would include those organizations with a composite UITRS rating of 3, 4, or 5; a transfer-agent rating of B or C; or significant deficiencies in one or more component-rating categories. In the case of an institution assigned a UITRS rating of 4 or 5 or a transfer-agent rating of C, supervisory action should be initiated promptly and continued until the problems or deficiencies have been appropriately addressed.

Under the Securities and Exchange Act of 1934, the Federal Reserve continues to be responsible for examining transfer agents and clearing agencies for which it is the primary supervisor, including reviewing compliance with SEC rules. Any material violations of transfer-agent or clearing-agency rules must be reported promptly to Board staff to facilitate coordination with the SEC.

## RISK PROFILE OF FIDUCIARY ACTIVITIES

Regular supervisory assessments of the risk of fiduciary activities, as outlined in SR-01-5, support the supervisory process. Risk profiles for LCBOs are updated quarterly in accordance with the provisions of SR-99-15. These risk profiles should include explicit consideration of the risks of fiduciary activities. For other complex fiduciary organizations, risk profiles reflecting fiduciary activities should be prepared and updated as needed, but no less frequently than annually. For these organizations, supervisory plans should detail the fiduciary specialist's recommended examination coverage of fiduciary activities. For banking organizations

supervised by the Federal Reserve that have smaller, noncomplex fiduciary operations, formal risk profiles may not be necessary. However, fiduciary-risk information should normally be updated at each examination or inspection and incorporated into supervisory plans.

Risk profiles should include an assessment of the inherent risk in the organization's fiduciary activities, as well as a consideration of the effectiveness of its risk management. Risk assessments would normally include the following factors:

- the size and number of fiduciary accounts and assets administered
- the nature and complexity of fiduciary products and services offered
- significant changes to management or staffing for fiduciary services
- significant changes to data processing systems supporting fiduciary services
- new affiliations, partnerships, or outsourcing arrangements
- changes in strategic direction affecting fiduciary services or exposure to emerging risks
- significant litigation, settlements, or charge-offs
- the length of time since the last on-site examination in which fiduciary activities were reviewed, and the scope of that examination
- the significance of prior examination findings
- the effectiveness of the organization's control environment, including its audit function, and the adequacy of its risk-management practices relative to the nature and scope of its business

## RISK FOCUS

As explained in SR-96-10, for a complex institution, fiduciary examiners will direct their attention to assessing the organization's func-

tions and its ability to identify, measure, monitor, and control fiduciary, market, credit, and operational risks. Examiners should assess risks that result from the fiduciary's investment-management, investment advisory, mutual funds, global custody, and securities-lending and processing activities. Any other activities that are subject to adverse movements in market rates or prices, or to operating problems associated with processing a large volume of securities, should also be assessed. These fiduciary activities could result in material losses to trust customers and, in turn, expose the institution to financial losses and litigation if not conducted in a manner consistent with the fiduciary's duty of loyalty and the investor's stated objectives.

A review of internal controls and policies and procedures is an integral part of the examination program. Facets of a fiduciary examination include management competence and accountability, management's review of risks associated with the introduction of new products and services, and management's overall risk awareness.

The emphasis on risk assessment and control parallels the guidelines and procedures pertaining to state member bank examinations and bank holding company inspections, as described in SR-95-51, and recognizes the efforts of many progressive institutions in establishing fiduciary-risk assessment and control initiatives of their own. When rating the quality of risk management of fiduciary activities, examiners should place primary consideration on findings relating to the following elements of a sound risk-management system: (1) active board and senior management oversight; (2) adequate policies, procedures, and limits; (3) adequate risk-measurement, -monitoring, and management information systems; and (4) comprehensive internal controls. Each of these elements is described further below, along with a list of considerations relevant to assessing the adequacy of each element.

## Active Board and Management Oversight

Given that a board of directors has ultimate responsibility for all of the activities of its institution, the board should approve overall fiduciary business strategies and policies, including those related to identifying, measuring, monitoring, and controlling fiduciary risks. A board

of directors must understand the nature of the risks that are significant to the organization, and it should ensure that management is taking the steps necessary to manage these risks.

Senior management has the responsibility for implementing approved strategies in a way that will limit fiduciary risks and ensure compliance with laws and regulations. Senior management should, therefore, be fully involved in the fiduciary activities of their institution and have sufficient knowledge of all fiduciary business lines to ensure that necessary policies, controls, and risk-monitoring systems are in place and that accountability and lines of authority are clearly defined. In assessing the quality of fiduciary oversight by boards of directors and senior management, examiners should consider whether these conditions exist:

- The board and senior management have a clear understanding and working knowledge of the types of fiduciary activities the institution performs and of the risks inherent in them. They have approved appropriate policies, procedures, recordkeeping systems, and reporting systems to support the fiduciary activities and to help measure and monitor risks. They have established procedures to stay informed about changes in fiduciary activities and the associated risks.
- Management at all levels adequately supervises the daily activities of officers and employees to ensure that the lines of fiduciary business are managed and staffed by persons whose knowledge, experience, and expertise are consistent with the nature and scope of the organization's fiduciary activities.
- Before offering new services or introducing new products, management identifies the fiduciary risks associated with them and ensures that internal controls are in place to manage the service or product and its accompanying risk.

## Adequate Policies, Procedures, and Limits

An institution's directors and senior management should establish fiduciary and fiduciary-risk management policies and procedures commensurate with the types of activities the institution conducts. The policies and procedures should provide enough detailed guidance

to ensure that all material areas of fiduciary activity and risk are addressed. They should also be modified when necessary to respond to changes in the organization's activities. A smaller, less complex institution that has effective management and that is heavily involved in daily operations generally would be expected to have more basic policies addressing the significant areas of its activities and setting forth a limited but appropriate set of requirements and procedures. In a larger institution, where senior management must rely on a widely dispersed staff to implement strategies in a wide range of complex situations, far more detailed policies and related procedures would be expected. In assessing the adequacy of an institution's fiduciary and fiduciary-risk management policies and procedures, examiners should consider whether these conditions exist:

- The institution's policies and procedures adequately address the fiduciary activities performed and are consistent with management's experience level and with the institution's stated goals and objectives.
- The institution's policies and procedures provide for adequate identification, measurement, monitoring, and control of the risks posed by its fiduciary activities.
- Policies clearly establish accountability and set forth lines of authority.
- Policies provide for review of new fiduciary services and activities to ensure that they are suitable and consistent with fiduciary-customer objectives, and to ensure that the systems necessary to identify, measure, monitor, and control risks associated with new services and activities are in place before the activity is initiated.

### Adequate Risk-Monitoring and Management Information Systems

Risk monitoring requires institutions to identify and measure all areas of material fiduciary risk continuously. Risk-monitoring activities must be supported by management information systems that provide senior management with timely reports on financial condition, operating performance, marketing efforts, new products and services, pending or threatened litigation, and risk exposure arising from fiduciary activities. The information system also must provide regu-

lar and more detailed reports for managers engaged in the daily management of the institution's activities.

The sophistication of risk-monitoring and control information systems should be commensurate with the complexity of the institution's fiduciary operations. Less complex institutions may require only a limited number of management reports to support risk-monitoring activities. Larger, more complex institutions, however, would be expected to have much more comprehensive reporting and monitoring systems. These systems would allow for more frequent reporting and closer monitoring of complex activities. In assessing the adequacy of an institution's measurement and monitoring of fiduciary risk, examiners should consider whether these conditions exist:

- The institution's fiduciary-risk monitoring practices and reports encompass all of its business lines and activities, and they are structured to monitor exposures consistent with established goals, limits, and objectives.
- Key assumptions, data sources, and procedures used in identifying, measuring, and monitoring fiduciary risk are appropriate for the activities the institution performs and are adequately documented and continuously tested for reliability.
- Reports to management are accurate and timely and contain sufficient information for policy and decision makers to identify any adverse trends and any potential or real problems. The reports must be adequate for management to evaluate the level of fiduciary risk faced by the institution.

### Adequate Internal Controls

A comprehensive internal-control structure is critical to the safe and sound functioning of an institution and its fiduciary-risk management system. Establishing and maintaining a system of internal controls that sets forth official lines of authority and an appropriate segregation of duties is one of management's most important responsibilities.

A well-structured system of internal controls promotes effective fiduciary operations and reliable reporting; safeguards assets; and helps to ensure compliance with laws, regulations, and institutional policies. Controls should be periodically tested by an independent party (prefer-



ably the auditor or at least an individual not involved in the process being reviewed) who reports directly to either the institution's board of directors or one of its designated committees. Given the importance of appropriate internal controls to organizations of all sizes and risk profiles, the results of these reviews should be adequately documented, as should management's responses to them. In evaluating the adequacy of an institution's internal controls as they relate to fiduciary activities, examiners should consider whether these conditions exist:

- The system of internal controls is appropriate to the type and level of fiduciary activities.
- The institution's organizational structure establishes clear lines of authority and responsibility.
- Reporting lines are sufficiently independent of the control areas and from the business lines, and there is adequate separation of duties throughout the institution.
- Financial, operational, and regulatory reports are reliable, accurate, and timely.
- Adequate procedures exist for ensuring compliance with laws and regulations.
- Internal-audit or other control-review practices provide for independence and objectivity.
- Internal controls and information systems are adequately tested and reviewed, with findings documented and weaknesses given appropriate and timely attention.
- The board of directors or the audit committee reviews the effectiveness of internal audits and other control-review activities regularly.

The fiduciary-risk assessment and control categories and tools listed above are not all-inclusive. They are guidelines for the fiduciary examiner and fiduciary-activities management to use in their risk-assessment and -control efforts. The examination of fiduciary activities may require some modification, depending on how the activities are organized and the complexity of the products and services offered.

## INVESTMENT OF FIDUCIARY ASSETS IN MUTUAL FUNDS AND POTENTIAL CONFLICTS OF INTEREST

Banks and trust institutions encounter various direct or indirect financial incentives to place

trust assets with particular mutual funds. These incentives include fees for using nonaffiliated fund families as well as incentives for using an institution's proprietary mutual funds. The primary supervisory concern is that an institution may fail to act in the best interest of its beneficiaries if it stands to benefit independently from a particular investment. As a result, an institution may be exposed to an increased risk of legal action by account beneficiaries, and it could potentially violate laws or regulations. The Federal Reserve Board issued SR-99-7 to help institutions minimize these risks and ensure that their activities meet fiduciary standards.

Institutions should ensure that they perform and document an appropriate level of due diligence before entering into any compensation arrangements with mutual fund providers or before placing fiduciary assets in their own proprietary mutual funds. SR-99-7 discusses the type of measures that should be included in this process, including a reasoned legal opinion addressing the activity, appropriate policies and procedures, and documented analysis and ongoing review of investment decisions. For issues pertaining to retail sales of nondeposit investment products and matters relating to compensation, see section 4170.1.

## Types of Financial Incentives

Financial incentives for placing trust assets with particular mutual funds range from payments structured as reimbursements for services or for transferring business to an unaffiliated fund family, to financial benefits that arise from using mutual funds that are managed by the institution or an affiliate. In some cases, such as service fees for administrative and recordkeeping functions performed by the trust institution, the permissibility of such payments may be specifically addressed under state law. However, guidance under applicable law may be less clear for other financial incentives. In all cases, decisions to place fiduciary assets in particular investments must be consistent with the underlying trust documents and must be undertaken in the best interest of the trust beneficiary.

Certain mutual fund providers offer compensation in the form of "service" fees to institutions that invest fiduciary assets in particular mutual funds. These fees, referred to variously as shareholder, subaccounting, or administrative-

service fees, are structured as payments to reimburse the institution for performing standard recordkeeping and accounting functions for the institution's fiduciary accounts, such as maintaining shareholder subaccounts and records, transmitting mutual fund communications as necessary, and arranging mutual fund transactions. These fees are typically based on a percentage or basis-point amount of the dollar value of assets invested or on transaction volume.

Nearly every state legislature modified its laws in the 1990s to allow explicitly the acceptance of such service fees by fiduciaries under certain conditions. These conditions often include compliance with standards of prudence, quality, and appropriateness for the account, and a determination of the "reasonableness" of the fees received by the institution. The Office of the Comptroller of the Currency (OCC) also adopted these general standards for national banks.<sup>1</sup> However, the Employee Retirement Income Security Act of 1974 (ERISA) generally prohibits fee arrangements between fiduciaries and third parties, such as mutual fund providers, with limited exceptions.<sup>2</sup> ERISA requirements supersede state laws and guidelines put forth by the bank regulatory agencies.

Although there has been no comprehensive review of the extent to which mutual fund providers are offering the types of incentive payments cited above, the practice is not uncommon. In addition to these service fees, another form of compensation reportedly offered by some mutual fund providers is a lump-sum payment based on assets transferred into a mutual fund.

Similar conflict-of-interest concerns are raised by the investment of fiduciary-account assets in mutual funds for which the institution or an affiliate acts as investment adviser (referred to as "proprietary" funds). In this case, the institution receives a financial benefit from management fees generated by the mutual fund investments.<sup>3</sup>

1. In general, national banks may make these investments and receive such fees if the practice is authorized by applicable law and if the investment is prudent and appropriate for fiduciary accounts and consistent with fiduciary requirements established by state law. These requirements include a "reasonableness" test for any fees received by the institution. (OCC Interpretive Letter No. 704, February 1996.)

2. ERISA section 406(b)(3), Department of Labor, Pension Welfare and Benefits Administration Advisory Opinion 97-15A and Advisory Opinion 97-16A.

3. A Board interpretation of Federal Reserve Regulation Y addresses the investment of fiduciary-account assets in mutual

## Due-Diligence Measures

Although many state laws explicitly authorize certain fee arrangements in conjunction with the investment of trust assets in mutual funds, institutions nonetheless face heightened legal and compliance risks from activities in which a conflict of interest exists, particularly if proper fiduciary standards are not observed and documented. Section 23B of the Federal Reserve Act (FRA) requires, before a member bank purchases shares issued by an affiliate, including investment-fund shares, that the board of directors approve the purchase based on a determination that the purchase is a sound investment for the bank, irrespective that an affiliate is the principal underwriter.<sup>4</sup> Even for investments in which the institution does not exercise investment discretion, disclosure or other requirements may apply. Therefore, institutions should ensure that they perform and document an appropriate level of due diligence before entering into any fee arrangements similar to those described above or before placing fiduciary assets in proprietary mutual funds. According to SR-99-7, the following measures should be included in this process:

- *A reasoned legal opinion.* The institution should obtain a reasoned opinion of counsel that addresses the conflict of interest inherent in the receipt of fees or other forms of compensation from mutual fund providers in connection with the investment of fiduciary assets. The opinion should address the permissibility of the investment and compensation under applicable state or federal laws, the trust instrument, or court order, as well as any applicable disclosure requirements or "reasonableness" standard for fees set forth in the law.
- *Establishment of policies and procedures.* The institution should establish written policies and procedures governing the acceptance of fees or other compensation from mutual fund providers, as well as the use of proprietary mutual funds. The policies must be reviewed and approved by the institution's board of directors or its designated committee. Policies

funds for which the trustee bank's holding company acts as investment adviser. In general, such investments are prohibited unless specifically authorized by the trust instrument, court order, or state law. See *Federal Reserve Regulatory Service* 4-177.

4. 12 USC 371c-1(b)(2).

and procedures should, at a minimum, address the following issues: (1) designation of decision-making authority; (2) analysis and documentation of investment decisions; (3) compliance with applicable laws, regulations, and sound fiduciary principles, including any disclosure requirements or reasonableness standards for fees; and (4) staff training and methods for monitoring compliance with policies and procedures by internal or external audit staff.

- *Analysis and documentation of investment decisions.* Where an institution receives fees or other compensation in connection with fiduciary-account investments over which it has investment discretion or where such investments are made in the institution's proprietary mutual funds, the institution should fully document its analysis supporting the investment decision. This analysis should be performed on a regular, ongoing basis and would typically include factors such as historical performance comparisons to similar mutual funds, management fees and expense ratios, and ratings by recognized mutual-fund rating services. The institution should also document its assessment that the investment is, and continues to be, appropriate for the individual account, in the best interest of account beneficiaries, and in compliance with section 23B of the FRA and with provisions of the "prudent-investor" or "prudent-man rules," as appropriate.

## UNIFORM INTERAGENCY TRUST RATING SYSTEM

In December 1998, the Federal Reserve Board issued implementing guidelines for the Uniform Interagency Trust Rating System (UITRS).<sup>5</sup> The revised UITRS was made effective for examinations commencing on or after January 1, 1999.<sup>6</sup> Federal Reserve examiners should assign UITRS ratings in conformance with the definitions adopted by the Federal Financial Institutions Examination Council (FFIEC), as augmented by the guidance below.

A full composite UITRS rating is *required* to

5. The UITRS was developed by the Federal Financial Institutions Examination Council. SR-98-37 mandated the use of UITRS for Federal Reserve examinations of fiduciary activities.

6. See 63 *Fed. Reg.* 54704 (October 13, 1998).

be assigned as a result of all trust examinations, except for targeted examinations, where component ratings need only be assigned for those areas included within the examination's scope. In those cases, component ratings should be assigned as the targeted examinations are completed. When an institution's trust activities are examined as a series of limited reviews over a period of time, the full UITRS rating should be assigned when the examination is considered complete, or at least as often as required under SR-01-05.

## Additional Considerations for Specific UITRS Components

### *Management*

The revised UITRS puts greater emphasis on assessing the quality of an institution's risk management, consistent with guidance previously provided to Federal Reserve examiners in SR-96-10. Examiners should continue to include in risk profiles and risk-management assessments the key risks outlined in SR-95-51, including reputation risk, operational risk, legal risk, credit risk, market risk, and liquidity risk. Whether all of these risks or a subset of them is relevant to the assessment of risk management, and thus to the management rating, depends on the scope of the particular institution's fiduciary activities. The other four UITRS rating components may also include consideration of the institution's ability to manage some or all of these risks.

### *Earnings*

Examiners must *evaluate* earnings for all institutions that exercise fiduciary powers. In addition, an earnings *rating* must be assigned for institutions that, at the time of the examination, have total fiduciary assets of more than \$100 million and for all nondeposit trust companies. For all other institutions, examiners are not required to assign a rating and should only do so in cases where fiduciary activities are significant and the earnings rating would be meaningful to the overall rating. In these cases, examiners should use the standard earnings-rating definition, rather than the alternate-rating definitions provided in the UITRS. For examinations where no earnings

rating is assigned, a rating of 0 should be given for the earnings component, and this component should be excluded from consideration in the composite rating.

Earnings ratings of 3 or worse should be reserved for institutions whose earnings performance indicates a supervisory problem requiring corrective action, which, if left unaddressed, may pose a risk to the institution. Federal Reserve examiners may, therefore, assign an earnings rating of 2 for an institution that has experienced losses in its fiduciary activities, provided that (1) management has determined that there are benefits to the overall institution or its community from offering fiduciary services, (2) losses from fiduciary activities are stable and consistent with management expectations, and (3) such losses do not have a significant adverse effect on the profitability of the institution as a whole.

### *Asset Management*

As noted in the UITRS, the asset-management component may not be applicable for some institutions because their activities do not involve the management of discretionary assets. A rating for asset management may, therefore, be omitted for examinations of institutions whose operations are limited to activities such as directed-agency relationships, securities clearing, nonfiduciary custody relationships, or transfer-agent or registrar activities. However, this component rating should be assigned for an institution that provides investment advice, even though it does not have discretion over the account assets. Where an asset-management rating is not assigned for a particular examination, a rating of 0 should be given, and this component should be excluded from consideration in the composite rating.

### **Examination Reports**

SR-96-26 requires that the UITRS rating be disclosed to the institution in the summary section of each examination report. In addition, the individual numerical component ratings, which should also be disclosed in the open section of the report, may be included in the summary section. If the component ratings are included in the summary section, the ratings should also be included in the open-section

pages of the report in which trust findings are presented. If the Reserve Bank prefers not to disclose the examiner's evaluation of the component ratings to the institution, this information may be included in the confidential section of the report. Regardless of where in the report it appears, the evaluation must include sufficient detail to justify the rating assigned.

### **UITRS Description**

Under the UITRS, the fiduciary activities of financial institutions are assigned a composite rating based on an evaluation and rating of five essential components of an institution's fiduciary activities. Composite and component ratings are assigned based on a 1-to-5 numerical scale. A 1 is the highest rating and indicates the strongest performance and risk-management practices and the least degree of supervisory concern. A 5 is the lowest rating and indicates the weakest performance and risk-management practices and, therefore, the highest degree of supervisory concern. The evaluation of the composite and components considers the size and sophistication, the nature and complexity, and the risk profile of the institution's fiduciary activities.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors that make up a particular component and on its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, the assignment of a composite rating may incorporate any factor that bears significantly on the overall administration of the financial institution's fiduciary activities. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

Management's ability to respond to changing circumstances and address the risks that may arise from changing business conditions, or from the initiation of new fiduciary activities or products, is an important factor in evaluating an institution's overall fiduciary-risk profile and the level of supervisory attention warranted. For this reason, the management component is given

special consideration when assigning a composite rating.

The ability of management to identify, measure, monitor, and control the risks of its fiduciary operations is also taken into account when assigning each component rating. It is recognized, however, that appropriate management practices may vary considerably among financial institutions, depending on the size, complexity, and risk profiles of their fiduciary activities. For less complex institutions engaged solely in traditional fiduciary activities and whose directors and senior managers are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. On the other hand, at more complex institutions, detailed and formal management systems and controls are needed to address a broader range of activities and to provide senior managers and directors with the information they need to supervise day-to-day activities.

All institutions are expected to properly manage their risks. For less complex institutions engaging in less risky activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

## Composite Ratings

Composite ratings are based on a careful evaluation of how an institution conducts its fiduciary activities. The review encompasses the capability of management, the soundness of policies and practices, the quality of service rendered to the public, and the effect of fiduciary activities on the soundness of the institution. The composite ratings are defined as follows.

### *Composite 1*

Administration of fiduciary activities is sound in every respect. Generally, all components are rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by management. The institution is in substantial compliance with fiduciary laws and regulations. Risk-management practices are strong relative to the size, complexity, and risk profile of the institution's fiduciary activities. Fiduciary activities are conducted in

accordance with sound fiduciary principles and give no cause for supervisory concern.

### *Composite 2*

Administration of fiduciary activities is fundamentally sound. Generally, no component rating should be more severe than 3. Only moderate weaknesses are present and are well within management's capabilities and willingness to correct. Fiduciary activities are conducted in substantial compliance with laws and regulations. Overall risk-management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

### *Composite 3*

Administration of fiduciary activities exhibits some degree of supervisory concern in one or more of the component areas. A combination of weaknesses exists that may range from moderate to severe; however, the magnitude of the deficiencies generally does not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Additionally, fiduciary activities may reveal some significant noncompliance with laws and regulations. Risk-management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. Although problems of relative significance may exist, they are not of such importance as to pose a threat to the trust beneficiaries generally or to the soundness of the institution. The institution's fiduciary activities require more-than-normal supervision and may include formal or informal enforcement actions.

### *Composite 4*

Fiduciary activities generally exhibit unsafe and unsound practices or conditions, resulting in unsatisfactory performance. The problems range from severe to critically deficient and may be centered around inexperienced or inattentive management, weak or dangerous operating practices, or an accumulation of unsatisfactory features of lesser importance. The weaknesses and

problems are not being satisfactorily addressed or resolved by the board of directors and management. There may be significant noncompliance with laws and regulations. Risk-management practices are generally unacceptable relative to the size, complexity, and risk profile of fiduciary activities. These problems pose a threat to the account beneficiaries generally and, if left unchecked, could evolve into conditions that could cause significant losses to the institution and ultimately undermine public confidence in the institution. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems.

### *Composite 5*

Fiduciary activities are conducted in an extremely unsafe and unsound manner. Administration of fiduciary activities is critically deficient in numerous major respects, with problems resulting from incompetent or neglectful administration, flagrant or repeated disregard for laws and regulations, or a willful departure from sound fiduciary principles and practices. The volume and severity of problems are beyond management's ability or willingness to control or correct. Such conditions evidence a flagrant disregard for the interests of the beneficiaries and may pose a serious threat to the soundness of the institution. Continuous close supervisory attention is warranted and may include termination of the institution's fiduciary activities.

## Component Ratings

The five key components used to assess an institution's fiduciary activities are (1) the capability of management; (2) the adequacy of operations, controls, and audits; (3) the quality and level of earnings; (4) compliance with governing instruments, applicable law (including self-dealing and conflicts-of-interest laws and regulations), and sound fiduciary principles; and (5) the management of fiduciary assets. Each of the component-rating descriptions is divided into three sections: a narrative description of the component, a list of the principal factors used to evaluate that component, and a description of each numerical rating for that component. Some of the evaluation factors are

repeated under one or more of the other components to reinforce the interrelationship among components.

### *Management*

The management rating reflects the capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's fiduciary activities. The rating also reflects the ability of the board of directors and management to ensure that the institution's fiduciary activities are conducted in a safe and sound manner and in compliance with applicable laws and regulations. Directors should provide clear guidance regarding acceptable risk-exposure levels and ensure that appropriate policies, procedures, and practices are established and followed. Senior fiduciary management is responsible for developing and implementing policies, procedures, and practices that translate the board's objectives and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's fiduciary activities, management practices may need to address some or all of the following risks: reputation, operating or transaction, strategic, compliance, legal, credit, market, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls that consider the size and complexity of the institution's fiduciary activities; and effective risk-monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of fiduciary activities in which the institution is involved.

The management rating is based on an assessment of the capability and performance of management and the board of directors, including, but not limited to, the following evaluation factors:

- the level and quality of oversight and support of fiduciary activities by the board of directors and management, including committee structure and adequate documentation of committee actions
- the ability of the board of directors and management, in their respective roles, to plan for and respond to risks that may arise from

- changing business conditions or the introduction of new activities or products
- the adequacy of and conformance with appropriate internal policies, practices, and controls addressing the operations and risks of significant fiduciary activities
  - the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems appropriate for the institution's size, complexity, and fiduciary-risk profile
  - the overall level of compliance with laws, regulations, and sound fiduciary principles
  - responsiveness to recommendations from auditors and regulatory authorities
  - strategic planning for fiduciary products and services
  - the level of experience and competence of fiduciary management and staff, including issues relating to turnover and succession planning
  - the adequacy of insurance coverage
  - the availability of competent legal counsel
  - the extent and nature of pending litigation associated with fiduciary activities, and its potential impact on earnings, capital, and the institution's reputation
  - the process for identifying and responding to fiduciary-customer complaints.

*Ratings of management.* A rating of 1 indicates strong performance by management and the board of directors and strong risk-management practices relative to the size, complexity, and risk profile of the institution's fiduciary activities. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board are proactive and have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

A rating of 2 indicates satisfactory management and board performance and risk-management practices relative to the size, complexity, and risk profile of the institution's fiduciary activities. Moderate weaknesses may exist, but are not material to the sound administration of fiduciary activities and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates management and board performance that needs improvement or risk-management practices that are less than satisfactory given the nature of the institution's fiduciary activities. The capabilities of management

or the board of directors may be insufficient for the size, complexity, and risk profile of the institution's fiduciary activities. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient management and board performance or risk-management practices that are inadequate considering the size, complexity, and risk profile of the institution's fiduciary activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to protect the assets of account beneficiaries and to prevent erosion of public confidence in the institution. Replacing or strengthening management or the board may be necessary.

A rating of 5 indicates critically deficient management and board performance or risk-management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk-management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution or its administration of fiduciary activities, and they pose a threat to the safety of the assets of account beneficiaries. Replacing or strengthening management or the board of directors is necessary.

### *Operations, Internal Controls, and Auditing*

The operations, internal controls, and auditing rating reflects the adequacy of the institution's fiduciary operating systems and internal controls in relation to the volume and character of business conducted. Audit coverage must ensure the integrity of the financial records, the sufficiency of internal controls, and the adequacy of the compliance process.

Fiduciary operating systems, internal controls, and the audit function subject an institution primarily to transaction and compliance risk. Other risks, including reputation, strategic, and financial risk, also may be present. The ability of management to identify, measure, monitor, and control these risks is reflected in this rating.

The operations, internal controls, and auditing rating is based on, but not limited to, an assess-

ment of the following evaluation factors:

- operations and internal controls, including the adequacy of—
  - staff, facilities, and operating systems;
  - records, accounting, and data processing systems (including controls over systems access and such accounting procedures as aging, investigation, and disposition of items in suspense accounts);
  - trading functions and securities-lending activities;
  - vault controls and securities movement;
  - segregation of duties;
  - controls over disbursements (checks or electronic) and unissued securities;
  - controls over income-processing activities; and
  - reconciliation processes (depository, cash, vault, subcustodians, suspense accounts, etc.)
- disaster or business-recovery programs—
  - hold-mail procedures and controls over returned mail, and
  - investigation and proper escheatment of funds in dormant accounts
- auditing, including—
  - the independence, frequency, quality, and scope of the internal and external fiduciary-audit function relative to the volume, character, and risk profile of the institution's fiduciary activities;
  - the volume or severity of internal-control and audit exceptions and the extent to which these issues are tracked and resolved; and
  - the experience and competence of the audit staff.

*Ratings of operations, internal controls, and auditing.* A rating of 1 indicates that operations, internal controls, and auditing are strong in relation to the volume and character of the institution's fiduciary activities. All significant risks are consistently and effectively identified, measured, monitored, and controlled.

A rating of 2 indicates that operations, internal controls, and auditing are satisfactory in relation to the volume and character of the institution's fiduciary activities. Moderate weaknesses may exist, but are not material. Significant risks, in general, are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates that operations, internal controls, or auditing need improvement in

relation to the volume and character of the institution's fiduciary activities. One or more of these areas are less than satisfactory. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient operations, internal controls, or audits. One or more of these areas are inadequate or the level of problems and risk exposure is excessive in relation to the volume and character of the institution's fiduciary activities. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action. Institutions with this level of deficiencies may make little provision for audits, or they may evidence weak or potentially dangerous operating practices in combination with infrequent or inadequate audits.

A rating of 5 indicates critically deficient operations, internal controls, or audits. Operating practices, with or without audits, pose a serious threat to the safety of assets of fiduciary accounts. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the ability of the institution to continue engaging in fiduciary activities.

### *Earnings*

The earnings rating reflects the profitability of an institution's fiduciary activities and their effect on the financial condition of the institution. The use and adequacy of budgets and earnings projections by functions, product lines, and clients are reviewed and evaluated. Risk exposure that may lead to negative earnings is also evaluated.

An evaluation of earnings is required for all institutions with fiduciary activities. An assignment of an earnings rating, however, is required only for institutions that, at the time of the examination, have total trust assets of more than \$100 million or that are a nondeposit trust company.

The evaluation of earnings is based on, but not limited to, an assessment of the following factors:

- the profitability of fiduciary activities in relation to the size and scope of those activities and to the overall business of the institution
- the overall importance to the institution of offering fiduciary services to its customers and local community



- the effectiveness of the institution's procedures for monitoring fiduciary-activity income and expense relative to the size and scope of these activities and their relative importance to the institution, including the frequency and scope of profitability reviews and planning by the institution's board of directors or a committee thereof

For those institutions for which a rating of earnings is mandatory, additional factors should include the following:

- the level and consistency of profitability, or the lack thereof, generated by the institution's fiduciary activities in relation to the volume and character of the institution's business
- dependence on nonrecurring fees and commissions, such as fees for court accounts
- the effects of charge-offs or compromise actions
- unusual features regarding the composition of business and fee schedules
- accounting practices that contain practices such as (1) unusual methods of allocating direct and indirect expenses and overhead, or (2) unusual methods of allocating fiduciary income and expense where two or more fiduciary institutions within the same holding company family share fiduciary services or processing functions
- the extent of management's use of budgets, projections, and other cost-analysis procedures
- methods used for directors' approval of financial budgets or projections
- management's attitude toward growth and new-business development
- new-business development efforts, including types of business solicited, market potential, advertising, competition, relationships with local organizations, and an evaluation by management of the risk potential inherent in new business areas

*Ratings of earnings.* A rating of 1 indicates strong earnings. The institution consistently earns a rate of return on its fiduciary activities that is commensurate with the risk of those activities. This rating would normally be supported by a history of consistent profitability over time and a judgment that future earnings prospects are favorable. In addition, management techniques for evaluating and monitoring earnings performance are fully adequate, and there is appropriate oversight by the institution's board of direc-

tors or a committee thereof. Management makes effective use of budgets and cost-analysis procedures. Methods used for reporting earnings information to the board of directors, or a committee thereof, are comprehensive.

A rating of 2 indicates satisfactory earnings. Although the earnings record may exhibit some weaknesses, earnings performance does not pose a risk to the overall institution nor to its ability to meet its fiduciary obligations. Generally, fiduciary earnings meet management targets and appear to be at least sustainable. Management processes for evaluating and monitoring earnings are generally sufficient in relationship to the size and risk of fiduciary activities that exist, and any deficiencies can be addressed in the normal course of business. A rating of 2 may also be assigned to institutions with a history of profitable operations if there are indications that management is engaging in activities with which it is not familiar or where there may be inordinately high levels of risk present that have not been adequately evaluated. Alternatively, an institution with otherwise strong earnings performance may also be assigned a 2 rating if there are significant deficiencies in its methods used to monitor and evaluate earnings.

A rating of 3 indicates less-than-satisfactory earnings. Earnings are not commensurate with the risk associated with the fiduciary activities undertaken. Earnings may be erratic or exhibit downward trends, and future prospects are unfavorable. This rating may also be assigned if management processes for evaluating and monitoring earnings exhibit serious deficiencies, provided the deficiencies identified do not pose an immediate danger to either the overall financial condition of the institution or its ability to meet its fiduciary obligations.

A rating of 4 indicates earnings that are seriously deficient. Fiduciary activities have a significant adverse effect on the overall income of the institution and its ability to generate adequate capital to support the continued operation of its fiduciary activities. The institution is characterized by fiduciary earnings performance that is poor historically or that faces the prospect of significant losses in the future. Management processes for monitoring and evaluating earnings may be poor. The board of directors has not adopted appropriate measures to address significant deficiencies.

A rating of 5 indicates critically deficient earnings. In general, an institution with this

rating is experiencing losses from fiduciary activities that have a significant negative impact on the overall institution, representing a distinct threat to its viability through the erosion of its capital. The board of directors has not implemented effective actions to address the situation.

*Alternate rating of earnings.* The UITRS alternate rating of earnings is *not* for use by Federal Reserve System examiners, per the December 1998 Federal Reserve UITRS implementing guidelines. For institutions where the assignment of an earnings rating is not required by the UITRS, an FFIEC federal supervisory agency has the option to assign an earnings rating using an alternate set of ratings. The alternate ratings are provided here so examiners will be able to interpret earnings ratings assigned by other banking supervisors that have adopted the alternate-rating system for earnings. Under the alternate-ratings scheme, alternate ratings are assigned based on the level of implementation of four minimum standards by the board of directors and management:

- *Standard No. 1.* The institution has reasonable methods for measuring income and expense commensurate with the volume and nature of the fiduciary services offered.
- *Standard No. 2.* The level of profitability is reported to the board of directors, or a committee thereof, at least annually.
- *Standard No. 3.* The board of directors periodically determines that the continued offering of fiduciary services provides an essential service to the institution's customers or to the local community.
- *Standard No. 4.* The board of directors, or a committee thereof, reviews the justification for the institution to continue to offer fiduciary services, even if the institution does not earn sufficient income to cover the expenses of providing those services.

*Ratings to be applied for the alternate rating of earnings.* A rating of 1 may be assigned where an institution has implemented all four minimum standards. If fiduciary earnings are lacking, management views this as a cost of doing business as a full-service institution and believes that the negative effects of not offering fiduciary services are more significant than the expense of administering those services.

A rating of 2 may be assigned where an institution has implemented, at a minimum,

three of the four standards. This rating may be assigned if the institution is not generating positive earnings or where formal earnings information may not be available.

A rating of 3 may be assigned if the institution has implemented at least two of the four standards. Although management may have attempted to identify and quantify other revenue to be earned by offering fiduciary services, it has decided that these services should be offered as a service to customers, even if they cannot be operated profitably.

A rating of 4 may be assigned if the institution has implemented only one of the four standards. Management has undertaken little or no effort to identify or quantify the collateral advantages, if any, to the institution from offering fiduciary services.

A rating of 5 may be assigned if the institution has implemented none of the standards.

### *Compliance*

The compliance rating reflects an institution's overall compliance with applicable laws, regulations, accepted standards of fiduciary conduct, governing account instruments, duties associated with account administration, and internally established policies and procedures. This component specifically incorporates an assessment of a fiduciary's duty of undivided loyalty and compliance with applicable laws, regulations, and accepted standards of fiduciary conduct related to self-dealing and other conflicts of interest.

The compliance component includes reviewing and evaluating the adequacy and soundness of adopted policies, procedures, and practices generally and as they relate to specific transactions and accounts. It also includes reviewing policies, procedures, and practices to evaluate the sensitivity of management and the board of directors to refrain from self-dealing, minimize potential conflicts of interest, and resolve actual conflict situations in favor of the fiduciary-account beneficiaries.

Risks associated with account administration are potentially unlimited because each account is a separate contractual relationship that contains specific obligations. Risks associated with account administration include failure to comply with applicable laws, regulations, or terms of the governing instrument; inadequate account-administration practices; and inexperienced man-

agement or inadequately trained staff. Risks associated with a fiduciary's duty of undivided loyalty generally stem from engaging in self-dealing or other conflict-of-interest transactions. An institution may be exposed to compliance, strategic, financial, and reputation risk related to account-administration and conflicts-of-interest activities. The ability of management to identify, measure, monitor, and control these risks is reflected in this rating. Policies, procedures, and practices pertaining to account administration and conflicts of interest are evaluated in light of the size and character of an institution's fiduciary business.

The compliance rating is based on, but not limited to, an assessment of the following evaluation factors:

- compliance with applicable federal and state statutes and regulations, including, but not limited to, federal and state fiduciary laws, the Employee Retirement Income Security Act of 1974, federal and state securities laws, state investment standards, state principal and income acts, and state probate codes
- compliance with the terms of governing instruments
- the adequacy of overall policies, practices, and procedures governing compliance, considering the size, complexity, and risk profile of the institution's fiduciary activities
- the adequacy of policies and procedures addressing account administration
- the adequacy of policies and procedures addressing conflicts of interest, including those designed to prevent the improper use of "material inside information"
- the effectiveness of systems and controls in place to identify actual and potential conflicts of interest
- the adequacy of securities-trading policies and practices relating to the allocation of brokerage business; the payment of services with "soft dollars"; and the combining, crossing, and timing of trades
- the extent and permissibility of transactions with related parties, including, but not limited to, the volume of related commercial and fiduciary relationships and holdings of corporations in which directors, officers, or employees of the institution may be interested
- the decision-making process used to accept, review, and terminate accounts
- the decision-making process related to account-administration duties, including cash

balances, overdrafts, and discretionary distributions

*Ratings of compliance.* A rating of 1 indicates strong compliance policies, procedures, and practices. Policies and procedures covering conflicts of interest and account administration are appropriate in relation to the size and complexity of the institution's fiduciary activities. Accounts are administered in accordance with governing instruments, applicable laws and regulations, sound fiduciary principles, and internal policies and procedures. Any violations are isolated, technical in nature, and easily correctable. All significant risks are consistently and effectively identified, measured, monitored, and controlled.

A rating of 2 indicates fundamentally sound compliance policies, procedures, and practices in relation to the size and complexity of the institution's fiduciary activities. Account administration may be flawed by moderate weaknesses in policies, procedures or practices. Management's practices indicate a determination to minimize the instances of conflicts of interest. Fiduciary activities are conducted in substantial compliance with laws and regulations, and any violations are generally technical in nature. Management corrects violations in a timely manner and without loss to fiduciary accounts. Significant risks are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates compliance practices that are less than satisfactory in relation to the size and complexity of the institution's fiduciary activities. Policies, procedures, and controls have not proven effective and require strengthening. Fiduciary activities may be in substantial non-compliance with laws, regulations, or governing instruments, but losses are no worse than minimal. Although management may have the ability to achieve compliance, the number of violations that exist, or the failure to correct prior violations, is an indication that management has not devoted sufficient time and attention to its compliance responsibilities. Risk-management practices generally need improvement.

A rating of 4 indicates an institution with deficient compliance practices in relation to the size and complexity of its fiduciary activities. Account administration is notably deficient. The institution makes little or no effort to minimize potential conflicts or refrain from self-dealing, and it is confronted with a considerable number of potential or actual conflicts. Numerous substantive and technical violations of laws and

regulations exist, and many may remain uncorrected from previous examinations. Management has not exerted sufficient effort to effect compliance and may lack the ability to effectively administer fiduciary activities. The level of compliance problems is significant and, if left unchecked, may subject the institution to monetary losses or reputation risk. Risks are inadequately identified, measured, monitored, and controlled.

A rating of 5 indicates critically deficient compliance practices. Account administration is critically deficient or incompetent, and there is a flagrant disregard for the terms of the governing instruments and interests of account beneficiaries. The institution frequently engages in transactions that compromise its fundamental duty of undivided loyalty to account beneficiaries. There are flagrant or repeated violations of laws and regulations and significant departures from sound fiduciary principles. Management is unwilling or unable to operate within the scope of laws and regulations or within the terms of governing instruments, and efforts to obtain voluntary compliance have been unsuccessful. The severity of noncompliance presents an imminent monetary threat to account beneficiaries and creates significant legal and financial exposure to the institution. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the ability of management to continue engaging in fiduciary activities.

### *Asset Management*

The asset-management rating reflects the risks associated with managing the assets (including cash) of others. Prudent portfolio management is based on an assessment of the needs and objectives of each account or portfolio. An evaluation of asset management should consider the adequacy of processes related to the investment of all discretionary accounts and portfolios, including collective investment funds, proprietary mutual funds, and investment advisory arrangements.

The institution's asset-management activities subject it to reputation, compliance, and strategic risks. In addition, each individual account or portfolio managed by the institution is subject to financial risks such as market, credit, liquidity, and interest-rate risk, as well as transaction and compliance risk. The ability of management to

identify, measure, monitor, and control these risks is reflected in this rating.

The asset-management rating is based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of overall policies, practices, and procedures governing asset management, considering the size, complexity, and risk profile of the institution's fiduciary activities
- the decision-making processes used for selection, retention, and preservation of discretionary assets, including adequacy of documentation, committee review and approval, and a system to review and approve exceptions
- the use of quantitative tools to measure the various financial risks in investment accounts and portfolios
- the existence of policies and procedures addressing the use of derivatives or other complex investment products
- the adequacy of procedures related to the purchase or retention of miscellaneous assets, including real estate, notes, closely held companies, limited partnerships, mineral interests, insurance, and other unique assets
- the extent and adequacy of periodic reviews of investment performance, taking into consideration the needs and objectives of each account or portfolio
- the monitoring of changes in the composition of fiduciary assets for trends and related risk exposure
- the quality of investment research used in the decision-making process and documentation of the research
- the due-diligence process for evaluating investment advice received from vendors or brokers (including approved or focus lists of securities)
- the due-diligence process for reviewing and approving brokers or counterparties used by the institution

This rating may not be applicable for some institutions because their operations do not include activities involving the management of any discretionary assets. Functions of this type would include, but not necessarily be limited to, directed-agency relationships, securities clearing, nonfiduciary custody relationships, and transfer-agent and registrar activities. In institutions of this type, the rating for asset management may be omitted by the examiner in accordance with the examining agency's implementing

guidelines. However, this component should be assigned when the institution provides investment advice, even though it does not have discretion over the account assets. An example of this type of activity would be where the institution selects or recommends the menu of mutual funds offered to participant-directed 401(k) plans.

*Ratings of asset management.* A rating of 1 indicates strong asset-management practices. Identified weaknesses are minor in nature. Risk exposure is modest in relation to management's abilities and the size and complexity of the assets managed.

A rating of 2 indicates satisfactory asset-management practices. Moderate weaknesses are present and are well within management's ability and willingness to correct. Risk exposure is commensurate with management's abilities and the size and complexity of the assets managed. Supervisory response is limited.

A rating of 3 indicates that asset-management

practices are less than satisfactory in relation to the size and complexity of the assets managed. Weaknesses may range from moderate to severe; however, they are not of such significance as to generally pose a threat to the interests of account beneficiaries. Asset-management and risk-management practices generally need to be improved. An elevated level of supervision is normally required.

A rating of 4 indicates deficient asset-management practices in relation to the size and complexity of the assets managed. The levels of risk are significant and inadequately controlled. The problems pose a threat to account beneficiaries generally and, if left unchecked, may subject the institution to losses and could undermine the reputation of the institution.

A rating of 5 represents critically deficient asset-management practices and a flagrant disregard of fiduciary duties. These practices jeopardize the interests of account beneficiaries, subject the institution to losses, and may pose a threat to the soundness of the institution.

### INTRODUCTION

Directors are placed in a position of trust by the bank's shareholders, and both statutes and common law place responsibility for the affairs of a bank firmly and squarely on the board of directors. The board of directors of a bank should delegate the day-to-day routine of conducting the bank's business to its officers and employees, but the board cannot delegate its responsibility for the consequences of unsound or imprudent policies and practices, whether they involve lending, investing, protecting against internal fraud, or any other banking activity. The board of directors is responsible to the bank's depositors, other creditors, and shareholders for safeguarding their interests through the lawful, informed, efficient, and able administration of the institution. In the exercise of their duties, directors are governed by federal and state banking, securities, and antitrust statutes, as well as by common law, which imposes a liability on directors of all corporations. Directors who fail to discharge their duties completely or who are negligent in protecting the interests of depositors or shareholders may be subject to removal from office, criminal prosecution, civil money penalties imposed by bank regulators, and civil liability. Title IX of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990 greatly enhanced the enforcement powers of the federal bank regulatory agencies, including the Federal Reserve Board. Section 5040 of this manual, "Formal Corrective Actions," describes those enforcement powers in greater detail.

### DIRECTOR SELECTION

The affairs of each state member bank are overseen by its board of directors. The initial directors are elected by the shareholders at a meeting held before the bank is authorized to commence business. Thereafter, they are elected at meetings held at least annually on a day specified in the bank's bylaws. The directors hold office for a stated tenure, generally ranging from one to three years, or until their successors

are elected and have qualified. No state member bank is to have less than five or more than 25 directors as specified in section 31 of the Banking Act of 1933. Various laws govern the election, number, qualifications, oath, liability, and removal of directors and officers, as well as the disclosure requirements for their outside business interests. Other laws pertain to certain restrictions, prohibitions, and penalties for securities dealers serving as directors, officers, or employees; director interlocks; purchases of assets from, or sales to, directors; commissions and gifts for procuring loans; embezzlement; abstraction; willful misapplication; false entries; political contributions; and other matters. The examiner must be familiar with these laws and the related regulations and interpretations.

### DIRECTOR INDEPENDENCE

Directors must exercise their independent judgment when managing the bank's affairs. A responsible board will not merely rubber-stamp management's recommendations, but will review them carefully before deciding whether they are in the bank's best interests. A board that is excessively influenced by management, a single director, or a shareholder, or any combination thereof, may not be fulfilling its responsibilities to depositors, other creditors, and shareholders. Diversification of the board of directors is important and can be accomplished by including directors with no ownership or family-ownership interest in the bank and who are not employed by the bank.

A bank's board of directors may include one or more advisory directors. Advisory directors generally do not vote but may provide additional information or advice to the voting directors. An advisory director who functions in that capacity is generally not subject to the same regulatory requirements as voting members and has less liability for the board's actions. However, if an advisory director exercises a degree of influence or control over the board or the bank that is not commensurate with that status, it is appropriate for examiners to subject that individual to the same standards as voting directors. Such a person might also be subject to the same liability standards as a voting director.

## DIRECTORS' RESPONSIBILITIES

Directors play a critical role in overseeing the affairs of the bank. Directors should understand that if they neglect to carry out their fiduciary duties and responsibilities, they may be financially liable if the bank fails or experiences loss. An examiner sometimes has to remind bank directors of the extent of their duties and responsibilities. Unless bank directors realize the importance of their positions and act accordingly, they are failing to discharge their obligations to the shareholders, depositors, other creditors, and the community.

### Selection of Competent Executive Officers

One of the board's most important duties is to select and appoint executive officers who are qualified to administer the bank's affairs effectively and soundly. The board is also responsible for removing officers who do not meet reasonable standards of honesty, competency, executive ability, and efficiency. The responsibility for selecting executive officers also entails retaining them and ensuring that competent successors can be promoted or hired to fill unanticipated voids. The board is responsible for evaluating the performance of the chief executive officer and approving the CEO's compensation. In many banks, the board also approves compensation for other executive officers.

A state member bank that has been chartered or undergone a change of control within the last two years, that is not in compliance with the minimum capital adequacy guidelines or regulations of the Board, or that is in an otherwise troubled condition must provide 30 days' written notice to its regulating Reserve Bank before it can add a director, promote an internal staff member to senior executive officer, or employ a new senior executive officer.

### Effective Supervision of Bank Affairs

The type and degree of supervision required of a bank's board of directors to ensure a bank is soundly managed involve reasonable business judgment and competence and sufficient time to become informed about the bank's affairs. Directors ultimately are responsible for the

soundness of the bank. If negligence is involved, a director may be personally liable. The responsibility of directors to supervise the bank's affairs may not be delegated to the active executive officers or anyone else. Directors may delegate to executive officers certain authority, but not the primary responsibility of ensuring that the bank is operated in a sound and legal manner.

### Adoption and Adherence to Sound Policies and Objectives

The directors' role is to provide a clear framework of objectives and policies within which the chief executive officer can operate and administer the bank's affairs. This framework is often accomplished through the use of strategic plans and budgets. The strategic plan would discuss long-term, and in some cases, short-term goals and objectives as well as how progress toward their achievement will be measured. The objectives and policies should cover all areas of the bank's operations. The board of directors is responsible for establishing the policies that govern and guide the day-to-day operations of the bank, so they should review and approve them from time to time. These policies are primarily intended to ensure that the risks undertaken by the banks are prudent and are being properly managed. This means that the board of directors must, as a group, have a fundamental understanding of the various types of risks associated with different aspects of the banking business, for example, credit risk, foreign-exchange risk, or interest-rate risk, and define the types of risks the bank will undertake. Some of the more important areas in which policies and objectives must be established include investments, loans, asset and liability management, profit planning and budgeting, capital planning, and personnel. Directors are also responsible for adopting policies and procedures required by law or regulation, such as real estate lending policies, a security program, an inter-bank liabilities policy, and a Bank Secrecy Act program. The examination of these policies is covered in other sections of this manual.

### Avoidance of Self-Serving Practices

A bank's directors bear a greater than normal responsibility for upholding safe and sound

practices in dealing with transactions involving other members of the directorate and their related interests. Directors' decisions must preclude the possibility of partiality or favored treatment. Unwarranted loans to a bank's directors or their interests can be a serious safety-and-soundness concern for the bank. Directors who become financially dependent on their bank normally lose their usefulness as directors. Other self-serving practices the examiner should watch for are—

- gratuities paid to directors to obtain their approval of financing arrangements or the use of particular services,
- the use of bank funds by directors, officers, or shareholders to obtain loans or transact other business (Directors should be especially critical of correspondent bank balances when officers, directors, or shareholders are borrowing from the depository bank. The Department of Justice's position is that certain interbank deposits connected with a loan to officers, directors, or shareholders of the depositing bank might constitute a misapplication of funds in violation of 18 USC 656), and
- transactions involving conflicts of interest (When board decisions involve a potential conflict of interest, the director with the potential conflict should fully disclose the nature of the conflict and abstain from voting on the matter. The abstention should be recorded in the minutes. The examiner should also be aware that ethical conflicts of interest can arise when a director or director-related firm performs professional services for the bank. For example, a director who is also the bank's legal counsel may not, in some situations, be able to advise or represent the bank objectively.).

## Awareness of the Bank's Financial Condition and Management Policies

### *Management Information Systems*

A management information system (MIS) provides the information, often originated from an institution's mainframe and microcomputers, necessary to manage an organization effectively. MIS should have clearly defined guidelines, policies, practices, standards, and procedures for the organization. These should be incorporated

in the development, maintenance, and use of MIS throughout the institution.

MIS is used by all levels of bank staff to monitor various aspects of bank operations, up to and including its overall risk-management process. Therefore, MIS should be supportive of the institution's longer term strategic goals and objectives. At the other extreme, these everyday financial accounting systems also are used to ensure that basic control is maintained over financial recordkeeping activities. Since numerous decisions are based on MIS reports, appropriate control procedures must be set up to ensure that information is correct and relevant.

### *Audits*

In May 1993, pursuant to requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the FDIC issued rules and guidelines that require all banks with total assets in excess of \$500 million to have annual audits by an independent public accountant. Copies of these audit reports are to be sent to the FDIC and the appropriate Federal Reserve Bank. Furthermore, the Federal Reserve encourages banks with assets of \$500 million or less to provide for annual audits by independent public accountants.

The board or a committee designated by the board should review the audit reports with the bank's management and the independent public accountants. The review should include—

- the scope of services required by the audit, significant accounting policies, and audit conclusions regarding significant accounting estimates;
- the adequacy of internal controls, and actions necessary to ensure the resolution of any problems or deficiencies; and
- the institution's compliance with applicable laws and regulations.

Many states have laws requiring directors' examinations of the bank. When the directors lack adequate knowledge of examination techniques and procedures, they are encouraged to employ a qualified accountant or other specialist to conduct all or part of this examination. The examining committee or the entire board should play an active role. Directors should obtain a clear understanding of the scope of the procedures to be employed, and the final report of the



directors' examination should be reviewed by the board of directors.

Further guidance on the use of audit reports and the reliance placed upon the work of external and internal auditors in the examination process can be found in the "Internal and External Audit Section" of this manual.

## Maintenance of Reasonable Capitalization

A board of directors has the responsibility for maintaining its bank on a sufficiently capitalized basis. Capital planning and capital adequacy are discussed in the manual section "Assessment of Capital Adequacy," and the examiner should be familiar with this information.

## Compliance with Banking Laws and Regulations

Directors must carefully observe that banking laws are not violated; they may be personally liable for losses arising out of illegal actions. In addition, civil money penalties can be assessed for unsafe and unsound actions that do not necessarily involve a violation of a banking law.

## Guarantee of a Beneficial Influence on the Community's Economy

One reason for approving a newly chartered bank for Federal Reserve membership is to meet a specific community need. Directors, therefore, have a continuing responsibility to provide those banking services which meet the legitimate credit and other needs of the community being served. Directors should be certain that the bank attempts to satisfy all legitimate credit needs of the community.

## BOARD MEETINGS

The board should conduct its business in meetings held as required by the bank's bylaws or state law. Regular meetings of the board should review statements showing the bank's financial condition and earnings; the investment portfolio; and loan activity, including past-due and

nonaccrual loans, charged-off or recovered loans, large new loans, and loans to insiders. Directors should also review and approve all policies annually, and review and approve all insurance policies as they are obtained or renewed. They should also review audit and examination reports and initiate action to correct any deficiencies noted, review correspondence with regulatory agencies, review pending litigation, and keep informed of any major prospective undertakings, such as mergers, acquisitions, or new branches or construction.

## Minutes of Board Meetings

The board should ensure that an accurate, adequate record of its actions is maintained. Such a record is usually kept in the form of minutes of the board meetings. The minutes should document the board's review of all regular items mentioned above as well as the review and discussion of all significant items that are not part of the regular meeting. Additionally, at a minimum, the minutes should record the attendance or absence of each director at each meeting, detail the establishment and composition of any committees, and note the abstention of any director from any vote. Examiners should review the minutes of board meetings, as well as a sample package prepared for a board meeting, to determine that directors are receiving adequate information to make informed, sound decisions. Meetings conducted by telephone, if allowable under state law, should be documented as thoroughly as regular meetings.

## BOARD COMMITTEES

Many boards elect to delegate some of their workload to committees. The extent and nature of the bank's activities and the relative expertise of each board member play key roles in the board's determination of which committees to establish, who sits on them, and how much authority they have. Thus, there is no ideal committee structure. However, committees frequently found in state member banks include the following:

- *Executive Committee*—may be empowered to act when the full board is unable to meet, for

example, between regular meetings. An executive committee is usually found in large institutions, where it relieves the full board of the burden of reviewing the details of financial statements and operational activities.

- *Audit Committee*—typically monitors compliance with bank policies and procedures, and reviews internal and external audit reports and bank examination reports. Because it is responsible for ensuring compliance, accuracy, and integrity throughout the organization, the audit committee should consist only of outside directors. The audit committee may supervise the bank's internal auditor and his or her staff directly by hiring personnel, evaluating their performance, and setting their compensation.
- *Loan Committee*—may be established to monitor underwriting standards and loan quality, and to ensure that lending policies and procedures are adequate. In most banks with loan committees, all new loans are reviewed by the loan committee either before or after funding, with the threshold for prior approval being the amount of either the loan or the aggregate debt to the borrower. The loan committee may also be responsible for the loan review function and for maintaining an adequate reserve for loan losses.
- *Investment or Asset-Liability Management Committee*—monitors the bank's investment policies, procedures, and holdings portfolio to ensure that goals for diversification, credit quality, profitability, liquidity, community investment, pledging requirements, and regulatory compliance are met. In some banks whose complexity warrants it, asset-liability management committees have been established to replace or supplement investment committees. An asset-liability management committee monitors the bank's balance sheet and external forces, notably interest rates, to help coordinate asset acquisition and funding sources.
- *Other Committees*—depending on the nature and complexity of the bank's business, the board may establish other committees to monitor such areas as trust, branching, new facilities construction, personnel/human resources, electronic data processing, and consumer compliance.

Minutes of all major actions taken by committees that play a significant role in managing the bank should be kept and meet the same

minimum standards used for minutes of meetings of the full board.

## COMPLIANCE WITH FORMAL AND INFORMAL ADMINISTRATIVE ACTIONS

Bank directors must ensure that management corrects deficiencies found in the bank. Instructions to do so may come from the Federal Reserve as a formal or informal administrative action, depending on the severity of the problem.

Formal actions, which include cease-and-desist orders and written agreements, are normally exercised when banks have serious problems. For less serious problems, the Federal Reserve issues informal actions such as a "memorandum of understanding." Informal actions are an agreement between the Reserve Bank and the bank that sets forth the required corrective actions. The Reserve Banks are generally responsible for monitoring compliance with both types of administrative actions. To assist in that process, the Reserve Bank normally receives and evaluates periodic progress reports from the bank. In addition, information is provided by the examiner who checks the bank's compliance with the action. The Reserve Banks may initiate additional supervisory action against the bank or individuals associated with it when compliance is insufficient. Or, if the bank's compliance with the action is satisfactory, the Reserve Banks may recommend modifying or terminating the enforcement action.

Examiners should briefly discuss compliance with any enforcement actions on the Examination Conclusions and Comments page and direct the board of directors' attention to the Compliance with Enforcement Actions page of the examination report. The type and date of the action or resolutions and parties to the action should be listed. In addition, the examiner should generally list each provision requiring action by the bank and provide a comment addressing compliance with that provision. The examiner should comment on how the bank accomplished compliance or the problems that have prevented compliance. While certain information might be better discussed in the confidential section of the report, it is appropriate to make all salient negative comments on the Compliance with Enforcement Actions page to ensure that the

directors are made aware of any deficiencies and/or exceptions that may exist.

The Reserve Bank may recommend termination or modification of a formal administrative action whenever it determines that such restraints have satisfactorily served their purpose and should be removed or modified. In these cases, the Reserve Bank will send a memorandum with the appropriate explanation to the Board's Division of Banking Supervision and Regulation (BS&R) for review and evaluation. BS&R and the Board's Legal Division, when appropriate, will prepare the documents necessary to terminate or modify the existing administrative action.

## DEPOSITORY INSTITUTION MANAGEMENT INTERLOCKS ACT

Under the Depository Institution Management Interlocks Act (Interlocks Act) as implemented by Regulation L, interlocking relationships of management officials of various nonaffiliated depository institutions are prohibited, depending on the asset size and geographical proximity of the organizations. The enforcement of the interlock provisions of the Interlocks Act encompasses full cease-and-desist powers.

The intent of the Interlocks Act is to foster competition among various depository institutions by prohibiting interlocking relationships of management officials. The prohibitions, how-

ever, do not generally apply to the following organizations and their subsidiaries:

- a depository institution that does not do business in the United States except as an incident to its activities outside the United States;
- an Edge or agreement corporation;
- a depository organization in formal liquidation or a similar type situation;
- a credit union being served by a management official of another credit union;
- a state-chartered savings and loan guaranty corporation; or
- a Federal Home Loan Bank or other bank organized solely for the purpose of serving depository institutions or solely for the purpose of providing securities clearing services and related services related to other depository institutions.

In addition, five other exceptions are permitted, with Federal Reserve Board approval, based on the public benefit that is derived from the interlocking relationship and on the competitive nature of the institutions involved. These exceptions are for—

- institutions located in low-income areas or controlled or managed by members of a minority group or by women,
- newly chartered institutions,
- institutions facing conditions endangering safety and soundness,
- institutions sponsoring a credit union, and
- institutions affected by loss of management officials due to changes in circumstances.

# Duties and Responsibilities of Directors

## Examination Objectives

Effective date November 1995

## Section 5000.2

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1. To determine whether the board of directors fully understands its duties and responsibilities.
2. To determine if the board of directors is discharging its responsibilities in an appropriate manner.
3. To determine whether the board of directors has developed adequate objectives and policies.
4. To determine the existence of any conflicts of interest or self-dealing.
5. To determine compliance with laws and regulations.

# Duties and Responsibilities of Directors

## Examination Procedures

Effective date November 2003

## Section 5000.3

1. Update the following and review for possible violations of law—
  - a. A list of directors to include—
    - home address (If the director was appointed or elected since the previous examination, state the number of years residing at present address.),
    - date of birth,
    - years as a director of the bank,
    - approximate net worth,
    - occupation,
    - citizenship,
    - common stock ownership (beneficial, direct, and indirect), and
    - bonuses, fees, etc.
  - b. A list of embezzlements, defalcations, misappropriations, mysterious disappearances, or thefts that have occurred since the last examination. That list should be signed by the chief executive officer or the auditor.
  - c. A list of management officials (as defined in the Depository Institution Management Interlocks Act) of the bank, its holding company, and holding company affiliates who are management officials of other depository institutions.
  - d. A list of the indebtedness of directors, executives officers, and principal shareholders to the bank examined and any other bank, along with a statement of the terms and conditions of each extension of credit.
2. Obtain or update a listing of all areas of the bank's operations that are administered under the provisions of written objectives and policies that have been developed by or with the approval of the board. Inform the examiners assigned to review those departments that a policy has been developed or an update has occurred.
3. Analyze the listing obtained in step 2, and note any area of banking activity for which policies should be developed.
4. Determine that the board has accepted its responsibility to effectively supervise the affairs of the bank and to be informed of the bank's condition by performing the following:
  - a. Obtain a complete set of the latest reports furnished to directors at the last meeting, and list the areas of operation covered by the reports.
  - b. Distribute copies of the reports to the examiners in other areas, and request that they determine if reports furnished to the board are prepared accurately, contain sufficient detail to allow the directors to make an intelligent decision, and are submitted on a timely basis.
  - c. Prepare a list of areas not reporting or of reports the board does not receive that are considered necessary to maintain adequate supervision. As guidelines, consider the following reports:
    - A monthly statement of condition or balance sheet and a monthly statement of income. Those statements should be in reasonable detail and should be compared with the prior month, with the same month of a prior year, and with the budget. The directors should receive explanations for all large variances.
    - Monthly statements of changes in all capital and reserve accounts. Such statements should explain any changes.
    - Investment reports that group the securities by classifications; that reflect the book value, fair market value, and yield; and that include a summary of purchases and sales.
    - Loan reports that list significant past-due loans, trends in delinquencies, rate reductions, non-income-producing loans, and large new loans granted since the last report.
    - Audit and examination reports. Deficiencies in these reports should produce a prompt and efficient response from the board. The reports reviewed and actions taken should be reflected in minutes of the board of directors meetings.
    - A full report of all new executive-officer borrowing at any bank.
    - A monthly listing of type and amount of borrowing by the bank.
    - An annual presentation of bank insurance coverage.
    - All correspondence addressed to the board of directors from the Federal

- Reserve and any other source.
- A monthly analysis of the bank's liquidity position.
  - An annual projection of the bank's capital needs.
  - A listing of any new litigation and a status report on existing litigation and potential exposure.
  - A thorough report on any major bank endeavor that each bank director is expected to make a decision on, including branch applications and major building plans.
- d. Determine the mechanism used to assign responsibility for correcting deficiencies noted in regulatory reports, internal audit reports, external audit reports, or any other reports to the board, and determine the board's system of determining compliance with such recommendations.
  - e. Determine how directors perform a director's examination, the frequency of such examinations, and what part the directors take in the process.
  - f. Review the bank's method of ensuring continued or resumed operations in the event of a disaster. Complete the emergency preparedness measures questionnaire for inclusion in the workpapers.
  - g. Review correspondence between the Federal Reserve and the bank to determine that it has been properly reported.
5. Determine evidence of conflicts of interest and self-dealing by—
    - a. obtaining and summarizing information on the business interests of directors, executive officers, and principal shareholders;
    - b. comparing that information to develop a list of directors who have business interests in common;
    - c. analyzing the interests of directors to determine if the board consists of a variety of individuals;
    - d. obtaining from the examiner assigned to assessment of capital adequacy a list of shareholders who own or control, either directly or indirectly, 5 percent or more of any class of voting security;
    - e. distributing a list of the insiders (directors, officers, and shareholders whose ownership of voting securities in the institution is more than 10 percent) and their related interests to the appropriate examining personnel to ascertain the extent of loans to or transactions with insiders and their interests (Those examiners should be alert for any relationships with insiders' interests that are not included on the list.);
    - f. requesting that the appropriate examiners determine if any transactions with insiders are on terms more favorable than those offered to other customers (If so, determine whether the board has approved such transactions.);
    - g. determining that directors have reviewed their correspondent bank accounts in relation to possible conflicts of interest arising from directors', officers', or shareholders' borrowing from depository banks; and
    - h. correlating all information on insider transactions, and preparing appropriate report comments.
  6. Obtain the minutes of the meetings of the board of directors, the charter, the bylaws, and the minutes of shareholders meetings.
    - a. Review and summarize the bylaws and charter of the organization, including any specific provisions on the requirements of directors. The resulting material should become a permanent part of the workpapers and should be updated at subsequent examinations.
    - b. Read and summarize the minutes of all meetings of the board since the last examination, making certain to—
      - list any actions taken in contravention of the bylaws;
      - record major actions taken by the board that are not a part of a normal monthly meeting;
      - record any resolution or discussion covering the development of or entrance into a new area, such as a geographic area, customer service, asset category, or liability category;
      - record the creation of any special committee and the area with which it is designed to deal;
      - determine that actions taken by standing committees are reviewed and ratified by the full board;
      - if the minutes specify any transactions with directors or their interests, determine that the abstention of any interested director from voting on the mat-

- ters is noted;
- if the minutes do not mention any director-related transactions that have been uncovered during the examination, inquire if the interested director did refrain from voting.
- c. Read and summarize the minutes of the board's annual organization meeting and—
- list standing committees and their members,
  - have examiners who are examining areas that have standing-committee supervision read and summarize the minutes of those committees, and
  - prepare a list of major areas of operation that are not monitored by specific committees.
- d. Read and summarize the minutes of any stockholders meetings. The summary should include a list of directors elected at the annual meeting, the number of shares present and voted, individuals acting as proxies, and specific action approved by shareholders.
- e. Ascertain during the review of shareholders meeting minutes that (1) shareholders' approval has been received; (2) the bank's charter has been amended, if necessary; and (3) compliance with appropriate state or federal statutes has been met for the following:
- any establishment of or change of a branch location
  - any issuance of preferred stock
  - any increase in capital stock, either through sale or a stock dividend
  - any reduction in capital stock (and ascertain whether the resultant capital is not below what is required by the capital adequacy guidelines)
  - any stock split
  - any bank pension plan established since the preceding examination
  - any bank involvement in a conversion, merger, or consolidation
  - all other matters subject to vote
- f. Determine the date of the annual shareholders meeting and if it was in compliance with the bylaws.
- g. Review the charter and/or bylaws for quorum requirements of shareholder meetings. Ascertain that, at any meeting, the quorum requirements were satisfied according to recorded requirements or by
- having more than one-half of the eligible shareholders represented.
- h. Review any stock option or stock purchase plan adopted since the preceding examination, and review such action for compliance with the various conditions involving charter and shareholder approval.
- i. Determine if any candidate was nominated for director, other than the slate nominated by bank management, and review for compliance with the appropriate state statute.
7. Determine that the directors have accepted their responsibility for selecting competent officers by—
- a. determining that the board or a committee thereof reviews, at least annually, the chief executive officer's performance in attaining or progressing toward attaining specific objectives or goals set by the board,
  - b. determining if a policy statement on personnel exists, and ascertaining what provisions the board has made for successor management,
  - c. determining if any management contracts exist and, if one does, obtaining a copy, summarizing the pertinent points, and determining the reasonableness of terms,
  - d. determining by inquiry how the remuneration of executive officers is set and who makes decisions concerning executive salaries, and
  - e. listing any titled individual who, by action of the board, is specifically excluded from being an executive officer.
8. Determine compliance with laws and regulations by—
- a. reviewing workpapers of other examination areas or discussing compliance with other examiners to determine any violations of laws or regulations concerning directors that were disclosed in these examination areas,
  - b. reviewing the nature and extent of violations discovered at prior examinations to determine if similar violations have occurred at this examination, and
  - c. correlating information obtained from the minutes of board meetings to the reports of officer borrowings that have been prepared at and forwarded from other banks to determine that all such

- borrowings have been reported to the board.
9. Determine compliance with the Foreign Corrupt Practices Act (15 USC 78dd-1 and -2) by—
    - a. reviewing the bank’s policy prohibiting improper or illegal payments, bribes, kickbacks, etc., to any foreign government official or other person or organization covered by the law;
    - b. determining how that policy has been communicated to officers, employees, or agents of the bank;
    - c. reviewing any investigation or study done by, or on behalf of, the board of directors on the bank’s policies and operations concerning the advance of funds in possible violation of the act;
    - d. reviewing the work done by the examiner assigned to internal control to determine whether internal or external auditors have established routines to discover improper or illegal payments;
    - e. analyzing the general level of internal control to determine whether there is sufficient protection against the inaccurate recording of improper or illegal payments on the bank’s books;
    - f. requesting that examiners working in other areas of the bank be alert for any transactions that might violate the provisions of the act;
    - g. compiling any information discovered throughout the examination on possible violations; and
    - h. performing procedures on suspected criminal violations as outlined in section 5020.3, “Overall Conclusions Regarding Condition of the Bank: Examination Procedures.”
  10. Answer the following questions. (This questionnaire is intended to be a quick review for determining that all laws and regulations pertaining to directors have been complied with. Questions should be answered “no” and sub-questions should be answered “yes.” Any deviation from this pattern indicates a violation or potential violation. Situations that are not judged to be violations require comments stating the basis for that judgment.)
    - a. Is the number of directors less than 5 or greater than 25 (section 31, Banking Act of June 16, 1933)?
    - b. Have any directors failed to qualify by reason of insufficient stock ownership (12 USC 72)?
    - c. Are any directors noncitizens of the United States (12 USC 72)? If so, has the citizenship requirement been waived?
    - d. Do more than one-third of the directors fail to reside in the state, territory, or district in which the bank is located, or within 100 miles of the bank’s head office (12 USC 72)?
    - e. Did more than one-third of the directors fail to reside in the state, territory or district in which the bank is located, or within 100 miles of the bank’s head office, for one year before election (12 USC 72)?
    - f. Are any transactions with directors or their related interests on more favorable terms than those offered to other customers (Regulation O (12 CFR 215))?
    - g. Do the deposit accounts of directors receive greater interest than those of other customers (section 22(e), Federal Reserve Act (12 USC 376))?
    - h. Have any provisions of a cease-and-desist agreement or order been violated (Rules of Practice for Hearings (12 CFR 263))?
    - i. Has any director, officer, or employee been convicted of a crime involving a breach of trust or act of dishonesty (section 8(g) of the Federal Deposit Insurance Act (12 USC 1829))? If so, has the FDIC approved his or her membership on the board or employment?
    - j. Have any tie-ins of services been authorized by the board (Regulation Y (12 CFR 225.7))?
    - k. Were any loans to bank examiners disclosed (Criminal Code—18 USC 212 and 213)?
    - l. Has the bank made any political contributions (Federal Election Campaign Act (12 USC 441b))?
    - m. Have any employees been found to have misappropriated funds, made false entries, or otherwise defrauded the bank (18 USC 656)?
    - n. Has an officer of the bank failed to make appropriate written reports when an embezzlement, misapplication, or similar transaction occurred (SR-579)?
    - o. Have any extortionate extensions of credit been discovered (18 USC 892–894)?
    - p. Have any checks been certified against



- uncollected funds (18 USC 1004)?
- q. Have unauthorized obligations of the bank been issued (18 USC 1005 and 1006)?
  - r. Has there been a change in control (Regulation Y (12 CFR 225.41–225.43))? If so, was the Federal Reserve notified and was the application approved?
  - s. Have any purchase-money loans been made that are secured by 25 percent or more of the stock of another secured bank (Regulation Y (12 CFR 225.41))? If so, have the appropriate authorities been notified?
  - t. Has the bank failed to maintain records of directors, executive officers, and principal shareholders and their related interests (Regulation O (12 CFR 215.8))?
  - u. Are management officials of the bank, or its holding company or holding company affiliates, also management officials of an unaffiliated depository institution or depository holding company (Regulation L (12 CFR 212))? If so—
    - was such relationship established prior to November 10, 1978, and previously permitted by section 8, Clayton Anti-Trust Act (15 USC 19)?
    - was prior approval of the Federal Reserve obtained for a relationship that was developed since November 10, 1978?
    - does the interlocking relationship meet the criteria of one of the exceptions permitted by Regulation L (12 CFR 212)?
    - is the management relationship with an institution whose—
      - principal offices or branches, excluding electronic terminals, are located in a different RMSA from the bank’s or its holding company’s offices or branches (does not apply if either institution has assets of less than \$20 million) (12 CFR 212.3(b))?
      - principal offices or branches, excluding electronic terminals, are located in another city, town, or village not contiguous or adjacent and 10 miles or more apart?
    - if the bank or its holding company has assets exceeding \$2.5 billion, does the interlocking management relationship exist with a nonaffiliated depository institution holding company with assets of \$1.5 billion or less?
  - v. Have any loans to executive officers been uncovered that were not reported to the board (Regulation O (12 CFR 215) and 12 USC 503)?
  - w. Has a majority of the board failed to preapprove extensions of credit to any of the bank’s executive officers, directors, or principal shareholders and their related interests when the total loans to the individual exceed the amount prescribed in Regulation O?
  - x. Has the bank notified executive officers and principal shareholders of their reporting requirements (Regulation O (12 CFR 215))?
11. Determine compliance with administrative actions by—
    - a. reviewing provisions of the document and
    - b. reviewing bank records and performing necessary procedures to isolate noncompliance.
  12. Evaluate the bank’s compliance with formal or informal administrative actions and prepare comments for page one of the examination report (SR-02-17 and SR-92-21). (See also section 5040.1.)
  13. Determine compliance with conditions imposed in the approvals of corporate filings for—
    - a. branches and relocation applications, including—
      - capital plans or capital injections,
      - fixed-asset limitations, and
      - CRA plans;
    - b. subordinated debt, operating subsidiaries, and interim bank applications, including—
      - capital plans and
      - prior review and appropriate clearance of disclosures.
  14. On the basis of the information obtained by performing the foregoing procedures, or any other procedures deemed appropriate, evaluate the adequacy and effectiveness of the board of directors. The evaluation should include, but is not limited to—
    - a. the frequency and effectiveness of meetings;
    - b. the effectiveness of board committees;
    - c. the directors’ role in establishing policy;
    - d. the adequacy of the policies and major inconsistencies therein;

- e. the quality of reports for directors, noting any deficiencies in information flows from operating management;
  - f. violations of laws and regulations;
  - g. whether any one person or group appears to control or dominate the board (if so, comment on any adverse effects on operating policies, procedures, or the overall financial condition of the bank); and
  - h. the board's responsiveness to recommendations from the auditors and supervisory authorities.
15. Update the workpapers with any information that will facilitate future examinations.

The purpose of this section is to guide the examiner in evaluating bank management. Although the directorate is an integral part of the overall management of a bank, the management appraisal examination program is concerned primarily with the active officers. A review of the quality of director guidance and supervision is covered in "Duties and Responsibilities of Directors."

It is the responsibility of directors to employ a competent chief executive officer. Thereafter, senior management normally assumes the responsibility to employ, maintain and educate a qualified staff. Since a direct relationship exists between the overall condition of a bank and the quality of management, the first priority in evaluating the condition of the bank is to make an accurate appraisal of the competency of the management team.

Management is responsible, not only for the operations of the bank and the quality of its assets on a day-to-day basis, but also for planning for the future. Senior management should be evaluated on its plans for maintaining or improving the condition of the bank in the future as well as on the bank's present condition. The depth of planning and a general forward looking attitude of executive officers should be considered when projecting future management impact. This should include an evaluation of management's efforts to provide for succession of senior bank officials.

The projection of future management impact involves an appraisal of the quality and quantity of senior and middle management. This assessment of course must be relative to the size and community circumstances of the bank. Examiners must not restrict their appraisals to the past and present. The past and present certainly are significant, requiring an in-depth analysis of financial condition, earnings and capital adequacy, both on an absolute basis and as a trend, but, the determination of what the management will do for the bank in the future is most significant. The System's goal is to prevent problems from developing rather than waiting for future examinations to identify deteriorating conditions.

Bank management receives strong pressure from customers, stockholders and competitors. Customers demand more for their money, in the form of both interest and services, and stockholders demand higher returns on their invest-

ments, both in dividends and increased market value of their stock. No bank is completely free from the pressure of competition and, for most institutions, this is one of the strongest forces felt. In the midst of those pressures, the clear mandate to bank management is to "perform." Performance is measured in terms of long-run profitability, liquidity and solvency. It is almost impossible for a bank to achieve those long-range goals unless careful planning and coordination bring efficiency to its activities. Management must recognize the bank's position in the market and make plans which will achieve the objectives set for the institution by the directors. It must be constantly alert to the need for continually upgrading and expanding services and facilities to support and encourage the bank's growth.

Both the directors and senior management have important roles in a bank's program of internal control and internal audit. Although directors have overall audit responsibility and should require that the auditor report directly to them, senior management normally is charged with the duty of maintaining a strong system of internal control.

The entire examination procedure, as outlined throughout this manual, is designed to provide a clear picture of both the present and anticipated future condition of the bank under examination. As a result, the reports and workpapers generated by the examination process will serve as a major tool for examiners in their evaluation of management. Examination procedures for various balance sheet accounts and departmental areas are designed to effect a comprehensive evaluation of internal control and internal and/or external audit, and will provide the examiner with insight into the degree of compliance with the bank's own written policies in such areas. Similarly, the examination procedures in "Loan Portfolio Management," "Investment Securities," "Funds Management," "Assessment of Capital Adequacy," and "Analytical Review and Income and Expense" are designed to lead to a detailed analysis of written objectives, policies and procedures in those management areas.

The examiner must take a practical approach to evaluating these features depending on the bank's characteristics. The examiner can have greater confidence in the continuity of top and middle management when it is known that the

bank has an inflow of new personnel at various levels and that training procedures and advancement policies will keep the organization viable and dynamic.

The examiner must be concerned with salary levels within the bank and must review information collected during the examination about the bank's employee benefits program. Salaries paid and benefits provided should be compared with those offered by an appropriate peer group, and inquiry should be made to determine the relationship between the bank's payroll structure and that offered by competitors for the same caliber personnel.

The examiner must judge the appropriateness of asset distribution in view of the bank's sources of funds. The examiner must evaluate the adequacy of the bank's capital position and expectations in view of asset quality and plans for growth and expansion. The overall management evaluation should be made by the examiner-in-charge, because he or she is in the best position to identify weaknesses and inconsistencies in policies. Although examiners-in-charge will rely heavily upon the information received from assisting examining personnel in various areas under review, it is their task to assemble all of such information into a composite picture of the quality of management.

Senior management is responsible for the quality of all bank personnel and for planning its own replacement. A bank's recruiting, training, and personnel development activities are vital to the development and continuity of a quality

staff. The examiner must evaluate those areas to determine the quality of overall management. Some features of good personnel management are:

- An organizational structure.
- Detailed position descriptions.
- Carefully planned recruiting.
- Appropriate training.
- Performance review.
- Salary administration.
- Provision for communication.

The examiner should identify and interpret trends that can reveal flaws in policy either as written or as practiced. The examiner should question the quality of management in any area in which he or she finds serious shortcomings or makes significant criticisms.

The examiner should be alert for situations in which top management dominates the board or where top management acts solely at the direction of either the board or a dominant influence on the board. Although it is extremely important for the directors to assume their appropriate role in setting objectives and formulating policy consistent with their responsibilities to the depositors, shareholders and regulators, dialogue with top management must occur. In banks where both directors and senior management recognize and assume their appropriate duties and responsibilities, areas for conflict are greatly reduced.

# Management Assessment

## Examination Objectives

Effective date March 1984

## Section 5010.2

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1. To determine the consistency of written objectives, policies, and procedures in the various asset, liability, and operational areas.
2. To determine that policies are being adhered to throughout the system.
3. To determine that management plans adequately for future conditions and developments.
4. To evaluate the adequacy of the bank's personnel practices as they relate to management continuity.
5. To evaluate management experience and depth.
6. To determine that management has established systems which facilitate efficient operation and communication.
7. To evaluate the propriety and soundness of management decisions.
8. To project the impact of management on the future condition of the bank.

# Management Assessment Examination Procedures

Effective date March 1984

## Section 5010.3

In the following procedural steps examiners should attempt to utilize already developed material from internal or external audit sources. Also, the examining resources and circumstances of the bank must be weighed in perspective to set the depth of scope for this area.

1. Obtain the following, if available:
  - a. Organization chart.
  - b. Management plan.
  - c. Administrative and personal manuals.
  - d. Marketing plan.
  - e. Resumes for all executive officers and department or division heads which have not been obtained in previous examinations.
  - f. A list of the salary of and other compensation paid to each executive officer.
  - g. A list of the salary ranges for other officers of the bank broken down by position.
  - h. A description of other employee benefits.
2. Become familiar with the quality of key personnel by:
  - a. Updating management briefs for all executive officers and department or division heads.
  - b. Distributing the updated management briefs to appropriate examining personnel and requesting that they be returned upon completion.
3. Review administrative manuals and:
  - a. Extract any policy statements contained therein.
  - b. Extract any general information considered relevant in appraising management.
  - c. Analyze the manual(s), in general, as useful management tools.
4. Review management plan and extract information concerning:
  - a. Areas of bank where increased or decreased officer staffing is planned.
  - b. Number of officers to be added or removed.
  - c. Qualification requirements for planned additional officers.
5. Establish the hierarchy of the organization by determining the functional responsibility levels of various officers and whether lines of authority are drawn in accordance with the organization chart.
6. Review the bank's marketing plan for specific programs being planned and general applicability to the institution.
7. Review the bank's schedule of salaries and make comparisons with similar information from an appropriate peer group. If deemed appropriate, compare salaries paid and benefits received in the bank to those of other institutions with which it competes directly. Determine whether the bank is paying salaries or bonuses to inactive officers or directors and, if so, determine that such payments have been disclosed to shareholders.
8. Determine whether any executive incentive compensation plans (performance bonuses) have been established and, if so;
  - a. Review specific provisions of the plans and determine the beneficiaries.
  - b. Review controls established to prevent the beneficiary(s) of the plan from understating noncash expenses (accrual expense accounts, provision for possible loan losses, etc.) or overstating noncash income (accrual income accounts).
9. Review the bank's activities with regard to developing personnel for senior management succession. At a minimum, this review should include:
  - a. An assessment of the quality of lower levels of management and the potential for advancement.
  - b. An assessment of the bank's officer hiring policies to determine that it is appropriate to meet the bank's current and future needs.
10. Obtain and analyze daily or other periodic reports submitted to executive management with the view of determining the usefulness of the reports in monitoring the condition and operation of the bank.
11. As the evaluation of the various areas of examination interest are being completed, discuss with assisting personnel:
  - a. Any of their observations indicative of the general morale level.
  - b. The technical proficiency of officers in their area.
  - c. The level of direct impact that officers have on the condition of their areas.
12. Review the section on "Analytical Review

- and Income and Expense” and extract any information related to financial planning that is considered relevant to evaluating management. Also consider the quality, depth and applicability of financial planning.
13. In conjunction with reviewing the work papers and comments generated during the examination:
    - a. Familiarize yourself with the bank’s written objectives and policies.
    - b. Analyze those policies and determine any inconsistencies in management areas.
    - c. Review any internal control and policy exceptions and any other criticisms made in connection with the examination of all areas of the bank.
    - d. Determine the extent to which improper implementation is negating the effect of written policies and procedures.
    - e. Review the appropriateness of asset distribution in view of the bank’s sources of funds.
    - f. Review the evaluation of the bank’s capital position and expectations in view of asset quality and plans for growth and expansion.
  14. In cases where previously obtained information is incomplete or where no records could be reviewed, interview appropriate management in order to judge quality and depth. The interview should be conducted in such a manner as to generate necessary information for determining:
    - a. Sources of information used to keep current.
    - b. Strengths and weaknesses of lower level personnel.
    - c. Succession of management and replacement of key personnel.
    - d. General management plan.
    - e. Methods of control utilized.
    - f. Workload factors and efficiency of personnel.
    - g. Frequency of staff meetings and how the communications system works.
    - h. Management projections for the institution over the next year.
    - i. Any major new proposal being considered or changes in asset mix or services.
    - j. The nature and degree of working relationship with directors.
    - k. The existence of any time-consuming outside activities of executive management.
  15. By reviewing the results of the preceding steps and performing any other procedures deemed appropriate, answer the following questions (normally these questions will serve as a summary of information obtained, thus compiling factual data to support your objective comments on management):
    - a. Have overall management objectives been set?
    - b. Does the bank forecast manpower requirements?
    - c. Are qualified people advanced from within?
    - d. Are supervisory personnel involved in the selection of new employees and given the right of acceptance or rejection?
    - e. Is management training given to those persons likely to assume higher level positions?
    - f. Are salaries competitive?
    - g. Are employee benefit programs competitive?
  16. Prepare comments on the quality of management supervision. The comments should, at a minimum, discuss the following:
    - a. General and technical ability.
    - b. Effectiveness.
    - c. Experience.
    - d. Any inconsistencies in written objectives, policies and procedures.
    - e. Any serious or widespread lack of proper implementation of written procedures.
    - f. An evaluation of the bank’s salary structure.
    - g. The promptness with which management addresses problems.
    - h. The extent to which executive management delegates and demands accountability.
    - i. Any evidence that executive management is more concerned with the operation of a functional area than with overall supervision of the bank.
    - j. The potential for upward movement of existing management personnel.
    - k. Management’s commitment to effecting corrective action in problem areas.
    - l. Unsafe or unsound management.
    - m. Any situation which might require close monitoring or removal of management.
  17. For banks that are subsidiaries of bank holding companies (BHCs), review the relative degree of centralized control by parent or the lead bank, and evaluate:

- a. The general level of management's dependence on central BHC staff.
- b. Independence on final credit decisions.
- c. Independence on investment decisions.
- d. Independence on operational practices or service fee arrangements.

While examiners may expect that economies of scale or optimization of tax, investment, or credit considerations on a consolidated basis may be beneficial to the entire

organization, examiners must be alert to the danger of such considerations becoming overly burdensome or unfair to the subsidiary bank being examined. (Reference Federal Reserve Policy Statement on Inter-corporate Income Tax Accounting Transactions of Bank Holding Companies and State Member Banks.)

18. Update the workpapers with any information that will facilitate future examinations.



# Management Assessment Internal Control Questionnaire

Effective date March 1984

## Section 5010.4

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1. Does the bank have an organizational chart?
2. If not, have lines of authority and reporting responsibility been formally established?
3. Does the bank have a full-time personnel manager?
4. Does the bank utilize written personnel manuals?
5. Does the bank utilize a system of written job descriptions, including descriptions for supervisory personnel?
6. Does the bank actively recruit personnel?
7. Does the bank perform background investigations of new employees?
8. Does the bank have a formal training program?
9. Does the bank utilize other than on-the-job training?
10. Does the bank utilize a graded salary scale?
11. Does the bank consider competition in preparing a salary range? If so, in what manner?
12. Does the top management at least annually review lower management?
13. Does the bank prepare or utilize a long-range forecast of economic conditions germane to its trade area?
14. Does top management consult with directors for their opinion of future condition?
15. Does the bank either employ an economist or utilize the services of an outside economic advisor?
16. Does senior management propose to the directors areas for policy decision?
17. Does the bank have a management succession plan?
18. Does the bank employ a marketing manager and/or outside marketing consultant?
19. Does senior management receive:
  - a. A brief statement of condition daily?
  - b. A daily liquidity report?
  - c. A listing of assets subject to quality limitations at least monthly?
  - d. An earnings statement on a comparative basis at least monthly?
20. Does the bank's auditing function audit the officer's adherence to general policy?
21. Are staff meetings held on a regular basis?
22. Are minutes kept for staff meetings?
23. Does the bank use a system of progress reports on specific projects?
24. Does the bank have a tax department or a tax consultant?

# Internal Controls—Procedures, Processes, and Systems (Required Absences from Sensitive Positions)

Effective date April 2009

## Section 5017.1

Examiners are expected to assess the adequacy of an institution's internal controls—the involved procedures, processes, and systems of its internal control structure. In so doing, they may refer to the available Internal Control Questionnaire(s) pertaining to the various transactions and activities discussed at the end of most sections of the manual. (See also section 1010.1.) When assessing the adequacy of a bank's internal control system and structure, the examiner needs to have a good understanding of the meaning of internal control and be able to evaluate its design and effectiveness. Internal control is a process initiated by a bank's board of directors, management, and other personnel, and is designed to provide reasonable assurance that specific objectives are achieved as to the bank's (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) extent of compliance with applicable laws and regulations.<sup>1</sup>

The concept of control structure involves the controls that have been established and the control environment—management's monitoring of procedures, activities, and attitudes. Internal control is part of the bank's basic operations.

The components of internal control are

- *Control environment*—the environment established by the bank's employees who are responsible for its operations, including their ethical values, integrity, and competence
- *Risk assessment*—the identification, analysis, and management of risks
- *Control activities*—the institution's established policies and procedures that are designed to provide assurance that appropriate actions, which are determined by management, are taken to address identified risks
- *Information and communication*—the bank's activities that provide the basis for the gathering and exchange of information that is needed to conduct, manage, and control the organization
- *Monitoring*—the bank's continuous monitor-

ing of the internal controls system and structure to allow for appropriate and necessary changes.

The components of internal control overlap the internal control objectives. The components of internal control must be addressed individually to assess their effectiveness relative to a specific objective.

The bank's board of directors and senior management have an important role in ensuring the adequate development, execution, maintenance, and compliance monitoring of the bank's internal controls. When determining the adequacy of a bank's management, examiners should carefully analyze and review its internal control systems, processes, and procedures.

### STATEMENT ON REQUIRED ABSENCES FROM SENSITIVE POSITIONS

One of the many basic tenets of internal control is that a bank needs to ensure that its employees in sensitive positions are absent from their duties for a minimum of two consecutive weeks. Such a requirement enhances the viability of a sound internal control environment because most frauds or embezzlements require the continuous presence of the wrongdoer. After making this assessment, the bank should require that employees in sensitive key positions, such as trading and wire transfer, not be allowed to transact or otherwise carry out, either physically or through electronic access, their assigned duties for a minimum of two consecutive weeks per year. The prescribed period of absence should be sufficient to allow all pending transactions to clear. The bank should also require that an individual's daily work be processed by another employee during the employee's absence. See SR-96-37, which emphasizes the need for a bank to conduct an assessment of significant risk areas before developing a policy on required absences from sensitive positions.

A comprehensive system of internal controls is essential for a bank to safeguard its assets and capital, and to avoid undue reputational and legal risk. Senior management is responsible for establishing an appropriate system of internal

1. For additional information on internal controls, see the Committee of Sponsoring Organizations of the Treadway Commission's study on internal controls, *Internal Control—Integrated Framework* (AICPA, 1992).

controls and monitoring compliance with that system. Although no single control element should be relied on to prevent fraud and abuse, these acts are more easily perpetrated when proper segregation and rotation of duties do not exist. As a result, the Federal Reserve reemphasizes the following prudent banking practices that should be incorporated into a bank's internal control procedures. These practices are designed to enhance the viability of a sound internal control environment, as most internal frauds or embezzlements necessitate the constant presence of the offender to prevent the detection of illegal activities.

When developing comprehensive internal control procedures, each bank should first make a critical assessment of its significant areas and sensitive positions. This assessment should consider all employees, but should focus more on those with authority to execute transactions, those with signing authority and access to the books and records of the bank, as well as those employees who can influence or cause such activities to occur. Particular attention should be paid to areas engaged in trading and wire-transfer operations, including personnel who may have reconciliation or other back-office responsibilities.

After producing a profile of high-risk areas and activities, it would be expected that a minimum absence of two consecutive weeks per year be required of employees in sensitive positions. The prescribed period of absence should, under all circumstances, be sufficient to allow all pending transactions to clear and to provide for an independent monitoring of the transactions that the absent employee was responsible for initiating or processing. This practice could be implemented through a requirement that affected employees take vacation or leave, the rotation of assignments in lieu of required vacation, or a combination of both so the prescribed level of absence is attained. Some

banks, particularly small community banks, might consider compensating controls such as continuous rotation of assignments in lieu of required absences to avoid placing an undue burden on the bank or its employees.

For the policy to be effective, individuals having electronic access to systems and records from remote locations must be denied this access during their absence. Similarly, indirect access can be controlled by not allowing others to take and carry out instructions from the absent employee. Of primary importance is the requirement that an individual's daily work be processed by another employee during his or her absence; this process is essential to bring to the forefront any unusual activity of the absent employee.

Exceptions to the required-absence policy may be necessary from time to time. However, management should exercise the appropriate discretion and properly document any waivers that are granted. Internal auditing should be made aware of individuals who receive waivers and the circumstances necessitating the exceptions.

If a bank's internal control procedures do not include the above practices, they should be promptly amended. After the procedures have been enhanced, they should be disseminated to all employees, and the documentation regarding their receipt and acknowledgment maintained. Additionally, adherence to the procedures should be included in the appropriate audit schedules, and the auditors should be cognizant of potential electronic access or other circumventing opportunities.

The development and implementation of procedures on required absences from sensitive positions is just one element of an adequate control environment. Each bank should take all measures to establish appropriate policies, limits, and verification procedures for an effective overall risk-management system.

# Internal Controls—Procedures, Processes, and Systems (Required Absences from Sensitive Positions) Examination Objectives

Effective date April 2009

Section 5017.2

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1. To determine whether a critical assessment has been performed of a bank's significant areas and sensitive positions.
2. To ascertain that sound internal controls exist, including policies and procedures that provide assurances that employees in sensitive positions are absent from their duties for a minimum of two consecutive weeks per year.
3. To ascertain whether the bank has taken all measures to establish appropriate policies, limits, and verification procedures for an effective overall risk-management system.
4. To establish that the appropriate audit schedules and the audits include a review of minimum absence policies and procedures, including potential electronic access or other circumventing actions by employees.

# Internal Controls—Procedures, Processes, and Systems (Required Absences from Sensitive Positions) Examination Procedures

Effective date April 2009

## Section 5017.3

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1. Determine that a profile of high-risk areas and activities is performed on a regular, periodic basis.
2. Ascertain if employees assigned to sensitive positions are required to be absent for a minimum of two weeks per year while—
  - a. pending, sensitive transactions are monitored while they clear, and
  - b. daily work is monitored and processed by another employee during the regularly assigned employee's absence.
3. Determine if required internal control procedures for minimum absences (for example, rotation of assignments, vacation or leave, or a combination of both) are being used in sensitive operations such as trading, trust, wire transfer, reconciliation, or other sensitive back-office responsibilities.
4. Ascertain if appropriate policies, limits, and verification procedures have been established and maintained for an effective overall risk-management system.
5. Determine whether the bank—
  - a. prohibits others from taking and carrying out instructions from the absent employees, and
  - b. prevents remote electronic access to systems and records involving sensitive transactions during the regularly assigned employee's required minimum two-week absence.
6. Ascertain if waivers from the bank's two-week minimum absence policies and procedures involving sensitive positions are documented.
7. Determine that the appropriate audit schedules and the audits include a review of such procedures, including potential electronic access or other circumventing actions by employees.

# Overall Conclusions Regarding Condition of the Bank

## Section 5020.1

Effective date April 2008

The examiner is encouraged to use objective criteria in evaluating various areas of the bank. However, there will always be a need for subjective judgment in an examination. Formulating an overall conclusion regarding the present and future condition of the bank requires the use of both objective criteria and subjective judgment. As experience is essential in evaluating information in areas requiring subjective judgment, the procedures in this section should be performed by the examiner-in-charge. In performing these procedures, the examiner's primary concerns are—

- to make the ultimate determination as to—
  - the solvency of the bank and its ability to meet maturing and unusual demands in the ordinary course of business,
  - adherence to safe and sound banking practice,
  - adherence to the law, and
  - the continued viability of the institution, and
- to communicate the results of the examination to the Federal Reserve System and the directors of the bank.

The evaluation of the overall condition of the bank is based on conditions found throughout the institution. Considerations include internal control and policy exceptions, violations of law and regulations, quality of management, adequacy of earnings and capital, quantities of criticized assets, and other identified deficiencies or irregularities. An evaluation of the future condition of the bank is based on the analysis of—

- management's plans as expressed by operating plans, the capital plan, and other projections,
- factors such as competition and economic conditions, and
- the overall present condition of the bank.

The primary information for evaluating the present condition of a bank is the findings and conclusions of the assisting personnel. The examiner-in-charge should weigh the importance and significance of all criticisms, exceptions, and deficiencies in attempting to discover any unfavorable trends or situations. Through review of the examination process, insight can be gained into such central issues as—

- present asset quality;
- current liquidity position;
- present capital adequacy;
- quality and performance of management;
- earnings performance, both past and present; and
- sources and applications of funds.

The examiner-in-charge usually will include remarks regarding those areas in the examination report. Although procedural areas of this manual deal specifically with each of those key items, the examiner-in-charge should use information from all phases of the examination. For example, when reviewing the bank's present capital position, the examiner-in-charge may use knowledge of the bank's asset and management quality to modify the conclusions of assisting personnel. The important point is that the examiner-in-charge is in the best position to assess all information provided by the examination process.

Factors affecting the future condition of the bank can generally be categorized as internal or external. The examiner's review of current condition flows naturally into an evaluation of internal factors affecting the institution's future prospects and condition. Among the items providing insight into future conditions are—

- earnings trends,
- successor-management plans,
- the budget or profit plan,
- the capital plan, and
- any other internally generated projections or forecasts.

Many banks will not have formal written plans or projections. In such cases, the examiner-in-charge must obtain from senior management or the board of directors information on their plans for matters such as—

- growth and expansion,
- capital,
- changes in the size and mix of assets, and
- changes in sources of funding.

In addition, examiners should remind senior management that any change in the general character of a bank's business or the scope of the corporate powers it exercises requires the prior approval of the Board under Regulation H.

The examiner should recommend that banks

that do not have formal plans or projections take advantage of any externally available tools to aid them in formulating these plans. In today's competitive market, strategic planning is a necessity for almost all banks, but especially for banks that are losing their market share or in which inefficiencies are depressing profitability.

If banks prepare budgets or profit plans, insight can be gained into the accuracy of balance-sheet and earnings projections by comparing actual and projected account balances. It also is beneficial to compare original projections with current projections to determine that adjustments are made on a timely basis. When four- or five-year projections are made, banks often formulate several forecasts based on different sets of assumptions. In such a situation, the examiner should attempt to determine the bank's most likely future course.

The examiner should attempt to gain access to any official material or internal workpapers that document or illustrate the bank's rationale in planning its future. The goal is to review the institution's decision-making process.

Banks are turning increasingly to off-balance-sheet activities to deliver services, effect payments, generate income, and hedge interest-rate risks. Banks have introduced a wide variety of new products and services to complement their more traditional activities. Although these new activities are useful and profitable, they contain an element of risk. Many of these new activities involve a contingent liability or other risk that is not reflected on the bank's balance sheet and, indeed, may not even be fully recognized by the bank. The examiner should be aware of how the bank manages and controls its off-balance-sheet risks. Examples of off-balance-sheet activities include—

- guarantee contracts, retained or contingent interests, and variable interests,
- commitments and innovative applications for standby letters of credit, and
- a wide variety of financial instruments and investment-security activities (including futures and forwards, warrants, puts, and calls).

Risk can be distinguished primarily as credit risk, liquidity, market (price, interest rate, foreign exchange), reputational, and legal risk, or risk resulting from internal control deficiencies. Examiners must be aware of the nature and extent of off-balance-sheet risks. The risks that

affect capital, liquidity, and compliance with laws should be evaluated for their potential effect on the safety and soundness of the bank.

In judging such controversial areas as capital adequacy and liquidity, the examiner should remember that, under ideal circumstances, management should be the expert on the bank's capitalization and liquidity position. Judgments on such matters should be generated internally, based on insight only management can possess. It is management that should know the bank's competitive situation, the economics of the service area, and the anticipated impact of those and other factors on its plans for growth and expansion. It is also management that has the greatest interest in the success of the bank. Accordingly, management and the directorate should choose a level of capitalization and liquidity consistent with their perception of the bank's situation rather than reacting to competitors or relying on pressures from regulators. However, specific judgments by the examiner are required, particularly in situations where a capital or liquidity position has fallen below what examiners consider to be acceptable norms. Objective justification for lower levels of capital or liquidity must be obtained and analyzed.

To properly evaluate the future prospects of a bank, the examiner must review external factors affecting the institution. Significant among those factors are the characteristics of a bank's area. Area refers to the bank's primary service area, which is defined as that area from which the bank receives approximately 75 percent of its deposits. Demographics of the area generally are available, and every bank should accumulate such information to aid in analyzing its current operations and planning for future operations. The absence of such information in an up-to-date form should be considered a deficiency. Included under examination procedures for this section is a listing of minimum information required to ascertain the demographics of a service area. The examiner-in-charge should make sure that information is compiled and should analyze it to determine whether management expectations appear justifiable in the circumstances.

In dealing with competitive factors, the examiner should review or compute the share of market for the bank under examination. Continuing records in that area establish an analyzable trend. Consideration also should be given to changes in the bank's statutory and regulatory environment, such as—

- changes in branching laws,
- changes in tax structure, and
- changes in laws affecting competition with other financial institutions.

Once the examiner has reached specific conclusions about the present condition and future prospects of the bank, or has noted serious deficiencies or detrimental trends, his or her conclusions and suggestions should be communicated to bank senior management, the board of directors, and the Federal Reserve Bank on a timely basis. In formulating discussion and written comments, the examiner should avoid the appearance of second-guessing management. Therefore, conclusions, judgments, and recommendations should be based on objective information generated throughout the entire examination process.

Before preparing examination report comments regarding the overall condition of the bank, the examiner-in-charge should consider the reporting objective. Once it is determined that problems exist in a bank, the underlying causes must be identified. Those underlying causes as well as specific problems or deficiencies should be covered in the comments. For example, if deficiencies in written lending objectives or policies or noncompliance with sound policies has resulted in the acquisition of sub-quality assets, the examiner's comments must address both cause and effect. The total of criticized assets should be cited as evidence of the underlying problem, and appropriate remedies, such as changing objectives or policies, should be suggested.

Examiners should remember that their ability to reach accurate conclusions regarding the overall present condition and future prospects of the bank and their skill in communicating the conclusions to management orally and in reports will, to a great extent, determine the effectiveness of the entire examination process.

The examiner's conclusions regarding the overall condition of the bank are summarized in a composite rating assigned in accordance with guidelines provided under the Uniform Interagency Bank Rating System (CAMELS). The composite rating represents an overall appraisal of six key assessment areas (components) covered under the CAMELS rating system: Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. The summary, or composite, rating, as well as each of the assessment areas, is delineated on a numerical scale of

one to five, one being the highest or best possible score. Thus, a bank with a composite rating of one requires the lowest level of supervisory attention, while a five-rated bank has the most critically deficient level of performance and therefore requires the highest degree of supervisory attention. When appraising the six key assessment areas and assigning a composite rating, the examiner weighs and evaluates all relevant factors. In general, these factors include the adequacy of the capital base, net worth, and reserves for supporting present operations and future growth plans; the quality of loans, investments, and other assets; the ability to generate earnings to maintain public confidence, cover losses, and provide adequate security and return to depositors; the ability to manage liquidity and funding (in particular, during periods of increased financial stress); the ability to meet the community's legitimate needs for financial services and cover all maturing deposit obligations; and the ability of management to properly administer all aspects of the financial business and plan for future needs and changing circumstances. The assessment of management and administration includes the quality of internal controls, operating procedures, and all lending, investment and operating policies; compliance with relevant laws and regulations; and the involvement of the directors, shareholders, and officials.

Although the composite rating is based loosely on the average of the six component scores, the examiner's judgment can and should play a major role in its determination. Thus, the examiner must assess the severity, particularly the potential impact, of individual weaknesses on the present and future viability of the bank. Significant problems will provide sufficient basis for deviating from the numerical-average approach to assigning the composite rating. However, whenever deviation from the numerical standards for the composite rating is necessary to accurately reflect the overall condition of the bank, the examiner must provide a full explanation of the reasons for such deviation. See the appendix (section A.5020.1) for a complete discussion of the uniform rating system and considerations to be taken into account when using it to evaluate the condition of a bank.

## SUBSIDIARIES OF BANK HOLDING COMPANIES

The composite rating of an individual subsidiary



bank should be based on the condition of that single entity. The quality of management and the financial condition of the consolidated organization will be useful in assessing the prospects and understanding the operations of the bank being examined. However, banks with weaknesses requiring corrective action should be identified as such. Then, appropriate supervisory focus can also be made at the consolidated level. Also, banks should be identified by type on an individual basis rather than by applying the consolidated organization's characteristic to each bank. For example, the capital and condition of a community bank should be judged by community bank standards, not by multinational or regional standards, even if the bank is owned by such an organization. This approach recognizes that two consolidated organizations of similar size may be composed of entirely different types of banks. Proper evaluation of each bank component should lead a bank holding company examiner to the most appropriate conclusion on the condition of the consolidated entity.

## CONFIDENTIALITY OF THE SUPERVISORY RATING AND OTHER NONPUBLIC SUPERVISORY INFORMATION

A February 28, 2005, interagency advisory reminds banking organizations of the statutory prohibitions on the disclosure of supervisory ratings and other confidential supervisory information to third parties. The agencies<sup>1</sup> learned that some insurers had requested or required banks and savings associations (financial institutions) to disclose their CAMELS rating during the underwriting process when those institutions had sought directors' and officers' liability (D&O) coverage.<sup>2</sup> The agencies responded by issuing the advisory specifically to remind all banking organizations that, except in very limited circumstances, they are prohibited by law from disclosing their CAMELS rating and other

nonpublic confidential supervisory information to insurers as well as other nonrelated third parties without permission from their appropriate federal banking agency. (See SR-07-19, SR-05-4, SR-96-26, and SR-88-37.)

Federal banking regulations provide that the report of examination, which contains the CAMELS rating, is nonpublic information and is the property of the agency issuing the report.<sup>3</sup> These regulations specifically provide that, except in very limited circumstances, banks and other financial institutions may not disclose a report of examination or any portion of the report, nor make any representations concerning the report or the report's findings, without the prior written permission of the appropriate federal banking agency.<sup>4</sup> The circumstances for release of nonpublic supervisory information may include disclosure to a parent holding company, a director, an officer, an attorney, an auditor, or another specified third party, as indicated in the regulations of the appropriate federal banking agency.<sup>5</sup> Any person who discloses or uses nonpublic information except as expressly permitted by one of the appropriate federal banking agencies or as provided by the agency's regulations may be subject to the criminal penalties provided in 18 USC 641.

The legal prohibition on the release of nonpublic supervisory information applies to all financial institutions supervised by the agencies, including bank and thrift holding companies, Edge corporations, and the U.S. branches or agencies of foreign banking organizations, which receive confidential supervisory ratings, including the RFI/C(D) rating, ROCA rating, CORE rating, and CAMEO rating.<sup>6</sup> As with the

3. For the Federal Reserve, see 12 CFR 261.2(c)(1), 261.20(g), and 261.22(e).

4. See 12 CFR 261.22.

5. See 12 USC 326 and 12 CFR 261.20(b) (exceptions).

6. RFI/C(D), ROCA, and CAMEO ratings are assigned by the FRB as a result of an examination or inspection. As of January 1, 2005, the FRB adopted a new rating system, RFI/C(D) ratings, for bank holding companies that replaces the former BOPEC rating system. RFI/C(D) ratings components are Risk management, Financial condition, potential Impact of the parent and nondepository subsidiaries on the subsidiary depository institutions, Composite, and Depository institution. For noncomplex bank holding companies with assets of \$1 billion or less, only risk-management and composite ratings are assigned. ROCA ratings are assigned to the U.S. branches, agencies, and commercial lending companies of foreign banking organizations. The ROCA rating components are Risk management, Operational controls, Compliance, and Asset quality. CORE ratings are assigned to complex holding company enterprises. The CORE rating components are Capital, Organizational structure, Relation-

1. The Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OCC).

2. As part of the examination process, a confidential supervisory rating, called a CAMELS rating, is assigned to each depository institution regulated by the agencies. See the appendix section A.5020.1 for a complete description of the Uniform Financial Institutions Rating System or CAMELS rating system.

CAMELS rating, these ratings are transmitted to the regulated institutions in reports of inspection or examination, which are the property of the agencies.

Financial institutions that receive requests for confidential supervisory ratings should refer all requesters to the following publicly available information in lieu of disclosing any confidential regulatory information, including the CAMELS rating. (See the National Information Center, on the Federal Financial Institutions Examination Council (FFIEC) website, [www.ffiec.gov/](http://www.ffiec.gov/).)

- for banks, an institution's quarterly reports of condition (Call Reports) (see 12 USC 1817)
- for holding companies or foreign banks with U.S. operations, an institution's quarterly and annual FR Y or H-(b)11 reports (see 12 USC 1844, 3106, 3108, 601–604a, and 611–631)
- for national banks, the annual disclosure statement (see 12 CFR 18.3)
- for banks, the institution's Uniform Bank Performance Report (UBPR), which is available to all interested parties at the website [www.ffiec.gov](http://www.ffiec.gov) and is designed for summary and in-depth analysis of banks; for savings associations, the Uniform Thrift Performance Report (UTPR), available from the OTS upon request
- an institution's publicly available filings, if any, filed with the appropriate federal banking agency (15 USC 78(l)(i)) or with the U.S. Securities and Exchange Commission
- any reports or ratings on the institution compiled by private companies that track the performance of financial institutions<sup>7</sup>
- any reports or ratings issued by private rating services on public debt issued by an institution
- any publicly available cease-and-desist order or enforcement proceeding against an institution<sup>8</sup>
- any reports or other sources of information on

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ship, and Earnings. CAMEO ratings are assigned to Edge corporations and the overseas branches and subsidiaries of U.S. banks. The CAMEO ratings components are Capital, Asset quality, Management, Earnings, and Operations and internal controls.

7. For bank rating services, see the guidance at [www.fdic.gov/bank/index.html](http://www.fdic.gov/bank/index.html).

8. Information on enforcement actions taken by the Federal Reserve may be found at [www.federalreserve.gov/boarddocs/enforcement/search.cfm](http://www.federalreserve.gov/boarddocs/enforcement/search.cfm). Information on enforcement actions taken by other federal agencies, such as the Securities and Exchange Commission, the Financial Crimes Enforcement Network, and the Department of Justice, as well as foreign authorities, may also be publicly available.

institution performance or internal matters created by the institution that does not contain information prohibited from release by law or regulation

The National Association of Insurance Commissioners (NAIC) was advised by the agencies that some insurers were inappropriately requesting or requiring disclosure of CAMELS ratings as a part of the underwriting process. The agencies requested NAIC's assistance in notifying insurance companies that this practice should be discontinued because of the confidential nature of the CAMELS rating.

## FORMAL AND INFORMAL SUPERVISORY ACTIONS

As a general rule, supervisory action should be considered when other more routine measures, such as formal discussions with a bank's principals or directors and normal follow-up procedures, have failed to resolve supervisory concerns. The Uniform Interagency Bank Rating System clearly identifies the more serious problem banks and distinguishes them from banks whose weaknesses or deficiencies are such as to warrant a lower degree of supervisory concern.

For example, the application of prompt and effective remedial action may keep the condition of a composite 3 bank from deteriorating and the bank from becoming a problem institution. To ensure problem areas receive adequate attention, all weaknesses should be clearly defined and corrective measures should be properly structured. This objective may best be achieved through the execution of a memorandum of understanding between the bank's board of directors and Reserve Bank officials. A memorandum of understanding is not a formal written agreement as prescribed in the Financial Institutions Supervisory Act of 1966 (as amended); it is a good faith understanding between the bank's directorate and the Reserve Bank concerning the principal problems and the bank's proposed remedies.

Banks rated composite 4 or 5 are clearly problem institutions that require close and constant supervisory attention. Unless specific circumstances argue strongly to the contrary, such banks will be presumed to warrant formal super-

visory action, that is, a written agreement or cease-and-desist order, as provided for in the Financial Institutions Supervisory Act of 1966. In addition, the Board of Governors is authorized to suspend and remove offending officers and directors of banks for certain violations and activities.

Although the decision to pursue formal or informal supervisory actions belongs to the Board of Governors or the Reserve Bank, the initial consideration and determination of whether action is necessary usually results from the examination process. Accurate and complete report comments that carefully delineate both the bank's weaknesses and deficiencies, as well as management's existing or planned corrective measures, will allow the Reserve Bank to make the most informed decision concerning appropriate supervisory action.

## CIVIL MONEY PENALTIES

Under provisions of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (P.L. 95-630), the Board of Governors is authorized to assess civil money penalties for violation of the terms of a final cease-and-desist order and violations of—

- sections 19, 22, and 23A of the Federal Reserve Act (respectively, reserve requirements and interest-rate limitations; limitations on loans by insured banks to their executive officers, directors, and principal shareholders; and limits on loans by insured banks to their affiliates);
- the prohibitions of title VIII of FIRA against preferential lending to bank executive officers, directors, and principal shareholders based on a correspondent-account relationship; and
- a willful violation of the change in Bank Control Act of 1978 (12 USC 1817(j)).

In determining the appropriateness of initiating a civil money penalty assessment proceeding, the Board has identified a number of relevant factors (see *Federal Reserve Regulatory Service*, 3-1605). In assessing a civil money penalty, the Board is required to consider the size of the financial resources and good faith of the respondent, the gravity of the violation, the history of previous violations, and such other matters as justice may require.

Examiners are responsible for the initial analyses on potential civil money penalties. Civil money penalties should be proposed for serious violations and for violations which, because of their frequency or recurring nature, show a general disregard for the law. After the examiner has reviewed the facts and decided to recommend a civil money penalty, he or she should contact the Reserve Bank for advice on proper documentation and any other assistance.

## SUSPICIOUS-ACTIVITY-REPORTING PROCEDURES

On April 2, 1985, the federal financial institutions supervisory agencies and the U.S. Department of Justice signed an agreement that requires the agencies to work toward improving the federal government's response to white-collar crime in federally regulated financial institutions. The primary goal of the agreement is to ensure full cooperation in the sharing of relevant information among the agencies—subject to existing legal restrictions—so that all available information may be used in criminal, civil, and administrative proceedings. In keeping with that goal, in 1985 the Federal Reserve, along with the other federal financial institutions regulatory agencies, issued procedures to be used by banks and other financial institutions operating in the United States to report known or suspected criminal activities to the appropriate law enforcement authorities and bank supervisors. Since 1996, the federal financial institutions supervisory agencies and the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) have required banking organizations to report known or suspected violations of law as well as suspicious transactions on a Suspicious Activity Report by Depository Institutions (SAR-DI). Law enforcement agencies use the information reported on the SAR-DI form to initiate investigations, and Federal Reserve staff use the information in their examination and oversight of supervised institutions.

### Suspicious Activity Report by Depository Institutions

#### *Filing*

A member bank must file a SAR-DI form with

the appropriate federal law enforcement agencies and the Department of the Treasury. (See section 208.62 of the Board's Regulation H.)<sup>9</sup> Member banks must prepare a SAR-DI form in accordance with the form's instructions (see SR-07-2 and the attached June 2007 SAR-DI form and instructions); the completed SAR-DI form is to be sent to the U.S. Treasury Department. A SAR-DI report form must be filed when an institution detects—

- insider abuse involving any amount,
- violations aggregating \$5,000 or more in which a suspect can be identified,
- violations aggregating \$25,000 or more regardless of a potential suspect, or
- transactions aggregating \$5,000 or more that involve potential money laundering or violations of the Bank Secrecy Act.

The management of a member bank must promptly notify its board of directors, or a committee thereof, of any SAR-DI form filed.

### *Time for Reporting*

A member bank is required to file a SAR-DI form within 30 calendar days after the date of initial detection of the facts that may constitute a basis for filing a SAR-DI form. If no suspect was identified on the date of detection of the incident requiring the filing, a member bank may delay filing a SAR-DI form for an additional 30 calendar days in order to identify the suspect. Reporting may not be delayed more than 60 calendar days after the date of initial detection of a reportable transaction. For violations requiring immediate attention, such as when a reportable violation is ongoing, the financial institution is required to immediately notify an appropriate law enforcement authority and the Board by telephone, in addition to filing a timely SAR-DI form.

### *Retention of Records*

A member bank must retain a copy of any

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9. The Board's SAR-DI form rules apply to state member banks, bank holding companies and their nonbank subsidiaries that do not report on a different SAR-DI form (for example, broker-dealers), Edge and agreement corporations, and the U.S. branches and agencies of foreign banks supervised by the Federal Reserve.

SAR-DI form filed, as well as the original or business-record equivalent of any supporting documentation, for a period of five years from the date of the filing of the SAR-DI form. Supporting documentation is to be identified and maintained by the bank, and it will be deemed to have been filed with the SAR-DI form. All supporting documentation must be made available to appropriate law enforcement agencies on request.

### *Referral of Criminal Matters and the Monitoring of SAR-DI Forms*

The Enforcement Section of the Division of Banking Supervision and Regulation has primary responsibility for the referral of criminal matters for the Federal Reserve System to the appropriate authorities. The Anti-Money-Laundering Policy and Compliance Section of the division develops, implements, and monitors the System's suspicious-activity-reporting examination procedures. SR-letters have been distributed within the Federal Reserve System. Letters relevant to the reporting of suspicious activities include SR-07-2, SR-01-29, and SR-03-17. Any inquiry relating to suspicious-activity reporting should refer to the applicable SR-letter.

### *Interagency Guidance on Sharing Suspicious Activity Reports with Head Offices and Controlling Companies*

On January 20, 2006, the federal banking agencies<sup>10</sup> issued for banking organizations the Interagency Guidance on Sharing Suspicious Activity Reports with Head Offices and Controlling Companies. The guidance confirms that (1) a U.S. branch or agency of a foreign bank may disclose a SAR-DI form to its head office outside the United States and (2) a U.S. bank or savings association may disclose a SAR-DI form to controlling companies,<sup>11</sup> whether

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10. The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, along with the Department of Treasury's Financial Crimes Enforcement Network.

11. A controlling company is defined as (1) a bank holding company, as defined in section 2 of the Bank Holding

domestic or foreign. The guidance notes that banking organizations must maintain appropriate arrangements for the protection of confidentiality of SAR-DI forms.<sup>12</sup>

The guidance does not address whether a banking organization may share a SAR-DI form with an affiliate other than a controlling company or head office, whether located inside the United States or abroad. Until further guidance on this topic is issued, banking organizations should not share SAR-DI forms with such affiliates.

## Examination Objectives

The examiner should determine if an institution has established internal procedures to ensure the prompt and accurate submission of all reports of suspected criminal activity to the appropriate authorities. The institution's procedures must comply with the requirements for suspicious-activity reporting in section 208.62 of the Board's Regulation H (12 CFR 208.62) and with the Bank Secrecy Act compliance program (12 CFR 208.63).

## Examination Procedures

The examiner should—

- determine whether the institution has a policy of reporting suspected criminal activity,
- determine how the policy has been communicated to officers and employees, and
- determine whether a person or department in the bank has been designated as being responsible for the filing of SAR-DI forms.

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Company Act, or (2) a savings and loan holding company, as defined in section 10(a) of the Home Owners' Loan Act. For purposes of the guidance, a controlling company also includes a company having the power, directly or indirectly, to (1) direct the management or policies of an industrial loan company or a parent company or (2) vote 25 percent of any class of voting shares of an industrial loan company or a parent company.

12. FinCEN concurrently issued similar guidance for securities broker-dealers, futures commission merchants, and introducing brokers in commodities. (See SR-06-1 and its attachments.)

## Reporting of Suspected Criminal Violations

During the course of an examination, if an examiner (1) uncovers a situation that is known or suspected to involve a criminal violation of any section of the United States Code or state law and (2) finds that no referral, or an inadequate referral, has been made by the bank, he or she should report the situation immediately to the appropriate Reserve Bank. If the situation warrants, a telephone call should be made to the examiner-in-charge (EIC) or the central point of contact (CPC), as applicable.

The examiner should follow up the call with the submission of a detailed report. The EIC or the CPC should promptly convey the information to the appropriate enforcement officer at the Reserve Bank, who will expeditiously notify and consult with the Enforcement Section in the Board's Division of Banking Supervision and Regulation. The examiner's report to the EIC or the CPC should be in the form of a memorandum that fully apprises the Reserve Bank of the situation. All of the information reported in the SAR-DI form, as well as information held by the institution to support the SAR-DI form, should be included in the memorandum. Copies of pertinent exhibits or material should be attached to the memorandum.

The examiner's report should be confined to clear-cut statements of fact and must not contain opinions as to the probability of indictment, conviction, or related matters. In all reports and workpapers, the examiner should be as specific as possible. For example, rather than using phrases such as "it is reported" or "the bank indicates," the examiner should identify who reported the matter and how it occurred. On each transaction reported, copies of all documentation should be obtained and placed in a separate file detailing who handled the transaction in the bank. The reporting of the matter within the bank should be chronologically referenced throughout the documentation. The copies of documentation should be initialed and dated by the examiner in case the original is destroyed. The documentation is extremely important to proving a particular transaction.

The examiner's initial notification of suspected criminal violations to the Reserve Bank and the transmittal of data should be accomplished without informing bank personnel. Only the Reserve Bank or a designated representative

should inform bank personnel or its board of directors of a suspected criminal violation that had not been reported by the bank or that had been inadequately reported by bank personnel.

After reviewing the information submitted by the examiner, the Reserve Bank will decide whether the facts support the examiner's contention that a possible unreported violation of the criminal statutes exists. If the Reserve Bank, after consulting with the Board's Enforcement Section, discovers that in a particular instance a bank failed to report the suspected criminal

violation using the SAR-DI form or that the bank made an inadequate referral and, upon request, still fails to file a report, the Reserve Bank's staff must then complete a SAR-DI form. Appropriate comments relating to a bank's failure, if any, to file all necessary SAR-DI forms promptly and accurately must be made in the report of examination of the bank. Repeated or serious problems in this area should be directed through the Reserve Bank to the Enforcement Section of the Division of Banking Supervision and Regulation.

# Overall Conclusions Regarding Condition of the Bank

## Examination Objectives

Effective date March 1984

Section 5020.2

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1. To reach conclusions regarding the present condition of the bank.
2. To reach conclusions regarding the future prospects of the bank.
3. To determine the bank's ability to meet demands in the ordinary course of business or reasonably unusual circumstances.
4. To determine the bank's adherence to safe and sound banking practices.
5. To formulate recommended action, when appropriate, based on those conclusions.
6. To communicate conclusions and recommendations both orally and in the examination report.

# Overall Conclusions Regarding Condition of the Bank Examination Procedures

Effective date May 1988

Section 5020.3

Inasmuch as the following procedures are largely dependent on information generated from all phases of the examination, the examiner-in-charge should complete this program during the final stages of the examination. The completion of this program generally can be best accomplished during the review of the workpapers.

1. Analyze any available information concerning the characteristics of the area in which the bank operates to determine the existence of any unusual situations, any significant trends, the potential impact on the bank of any expected changes or any other significant information which could be detrimental to the bank. The bank should be consulted for sources of information which might include the most recent census data or data generated by organizations, such as the Chamber of Commerce. In analyzing the bank's trade area:
  - a. Consider density, income levels, general age group of the residents. Determine if there are significant changes in any of the above factors.
  - b. Determine the predominant living accommodations in the area (owner occupied vs. rental), price/rent levels and availability of residential units. Determine whether there are any major residential construction projects, re-zoning or conversions of single to multiple units which will have a significant effect on the bank.
  - c. Consider the types of industry and the number of firms in the area with emphasis on determining concentrations or seasonality. Investigate any major labor contract expirations, competitive factors or other significant factors which could have a negative effect on the community.
  - d. Consider the types of major products, available markets and present and projected prices for the products.
  - e. Consider any expected changes in street facilities which will significantly affect bank's accessibility/convenience. Determine the availability of public transportation.
  - f. Review the number and types of institutions that provide similar financial services in the community. Consider the aggressiveness, hours of business and additional services offered by competitor institutions.
- g. Determine the effect of government employment or dependence on government contracts on the community.
- h. Consider the condition of the national economy with particular attention to the rate of inflation, national vs. local unemployment, current interest rates and government fiscal and monetary policy. Specific problems, peculiar to a particular area should be investigated more thoroughly.
2. Review comments and conclusions contained in the workpapers which were generated throughout the examination and perform the following:
  - a. Compile all criticisms, exceptions and deficiencies.
  - b. Determine the existence of contradictory conclusions.
  - c. Consider the relative significance of criticisms, exceptions, deficiencies and conclusions and segregate important criticisms for the final review with management and for incorporation into the report of examination.
3. Based on procedures performed and conclusions contained in the workpapers, answer the following specific questions. These questions are intended as guidelines to the examiner-in-charge in formulating overall conclusions regarding the condition of the bank and should be augmented by the examiner's knowledge of the bank. "Yes" answers, in many instances, evidence the existence of a "leading" indicator of deterioration of bank soundness. For any question with a "yes" answer, specify any mitigating circumstances in the comments column. Sub-question answers are for information purposes.
  - a. *Asset Quality*
    - Is there an increasing ratio of criticized assets to total capital?
      - If so, is it indicative of adverse economic conditions, poor credit



judgment, or other factors (specify)?

- Has there been a material increase in the quantity of non-earning assets?
- Is there any abnormally increasing trend of past-due loans and/or interest earned but not collected?
  - If so, is it indicative of general economic conditions in the bank's trade area
  - Is the trend indicative of a weakening of collection policies and procedures, a slackening of credit standards, the bank's failure to recognize an asset which should be in a non-earning category, or is it caused by some other factor?
- Has a trend developed wherein the bank assumes increased risk without receiving increased rewards?
- Do the portfolios exhibit high concentrations in specific industries?
  - If so, do the concentrations represent a significant actual or contingent problem?
- Has the overall quality of assets deteriorated since the last examination?
  - If so, is the deterioration recognized by management and the board of directors? Can the deterioration be attributed to factors beyond the control of management or the board of directors, such as a change in the general economic conditions of the bank's service area?
    - If deterioration results from internal factors, such as lowering of credit standards or poor credit judgment, have steps been taken by management to effectively reverse negative trends?

#### b. *Quality of Management*

- Has the executive management changed since the last examination?
  - If so, is the change detrimental to the bank?
- Has there been any change in the general banking philosophy of executive management?
  - If so, is that detrimental to the bank?
- Do key bank officers have educational and/or experience levels below that considered minimal in the circumstances?
- Is there any tendency toward over reliance on essentially untrained and unskilled clerical staffs?
- Is there a large disparity between the compensation level of the chief executive officer and other members of executive management?
  - If so, is that disparity an objective indication of disproportional domination of the bank's affairs?
- Has the bank instituted any systems which directly reward managers for increasing bank income from assets or services subject to their control?
  - If so, has the bank failed to institute necessary control and audit procedures to prevent abuses?
- Has the bank failed to institute any programs which would give officers a vested interest in remaining with the bank?
  - If so, would the institution of such a program offer a workable solution to an actual or potential officer turnover problem?
- Is the bank's strategic and operational planning inadequate?
- Is the board of directors unresponsive to internal or external suggestions for improvement in the bank?
- Are the following conditions present?
  - Infrequent meetings of board of directors.
  - Infrequent meetings of committees of the board.
  - Infrequent management committee meetings.
  - A directorate which is split into distinct voting groups.
  - If so, are directors viewed as failing to perform their functions adequately?
- Is the quality of management deemed inadequate to conduct the affairs of the bank in a reasonable and safe manner?
- Are training programs and compensation increments deemed inadequate to attract and retain a staff capable of providing management succession?

c. *Earnings*

- Are earnings static or moving downward as a percentage of total resources?
- Is there a trend of decreasing income before security gains and losses as a percentage of total revenues?
  - If so, is such a trend expected to continue?
  - If so, has management determined causes for any deterioration and taken action to reverse the negative trend?
- Has the ratio of operating expenses to operating revenues been increasing?
- Are earnings trends consistent?
- Has a decreasing spread between interest earned and interest paid developed?
- Are the bank's earnings significantly vulnerable to changes in interest rate levels?
  - If so, what are management's plans and prospects for altering the vulnerability?
- Are there any significant structural changes in the balance sheet which may impact earnings?
- Has the bank experienced increasing actual loan losses and/or loan loss provisions?
- Is there any evidence that sources of interest and other revenues have changed since that last examination?
  - If so, is that attributed to an unsound emphasis for increased earnings?
- Are earnings deemed inadequate to provide increased capitalization commensurate with the bank's growth?

d. *Capital*

- Has the bank been unable to maintain a normal growth rate for capital?
- Do the ratios of loans to capital, deposits to capital or total assets to capital exhibit a trend to abnormal increases?
- Is capital deemed inadequate to support the present volume of business, including the volume of off-balance-sheet activities, in view of the amount

of criticized assets, the competency of management, etc.?

e. *Liquidity*

- Is there a trend toward decreasing bank liquidity?
- Has the bank been forced to increase abnormally dependence on borrowed funds to support existing assets?
- Does the bank depend excessively on purchased funds?
- Is there a trend toward investing interest sensitive liabilities in non-interest sensitive assets?
- Do the present quantity and maturity of non-interest sensitive assets represent a dangerous or potentially dangerous situation?

f. *Off-Balance-Sheet Risk*

Loans Sold or Serviced

- Is the bank involved as the lead or agent in loan participations, syndications, or servicing activities to the extent that management expertise is inadequate, or to the extent that the volume exceeds the level which management can capably handle?
- Does the bank's record of pending or threatened litigation indicate any instances where the bank, as lead or agent in a loan participation or syndication, has willfully misrepresented the credit to the other participants, or otherwise acted with gross negligence in handling the credit?
  - If so, is there any indication that the participants intend to hold the bank liable for any loss incurred on the credit?
- Did the examination reveal a practice of improper origination and packaging of loans sold or serviced which could cause:
  - The bank being compelled to repurchase the package, or
  - In the case of government guaranteed loans, the complete or partial dishonor of the guaranty?

- Has the bank previously repurchased participations when a loss was incurred, although it was not legally required to do so?

#### Letters of Credit

- Is there a trend toward increasing the issuance of standby letters of credit or other similar credit instruments?
  - If so, has the bank failed to consider the full impact of funding a significant percentage of those instruments?
- Are letters of credit excluded from the bank's internal loan review program?
- Does the internal evaluation of letters of credit include consideration of country and currency risk as well as credit risk?
- Is there a declining trend in the credit quality of letters of credit?
- Are standby letters of credit issued for purposes not covered in the bank's lending policy, or for which management does not have the expertise to handle?
- If not authorized in the bank's lending policy, were proper approvals obtained prior to issuance?

#### Wire Transfer Department

- Do internal control deficiencies in the wire transfer department pose a threat for large potential losses through fraud or error?
- Are there internal control deficiencies in the receiving and conveying of messages for other parties which may expose the bank to litigation for improper handling of the messages?

#### Data Processing Department

- Are internal controls inadequate in the bank's data processing area?
  - Are control deficiencies such that the accuracy and/or timeliness of data is questionable?
  - Are deficiencies such that the bank, in performing data processing services for others, could be liable for

- misplacement or other improper handling of source data?
- Are the bank's computer hardware and software systems inadequate to support the present and anticipated level of operations?
  - Are deficiencies such that hardware and systems will require replacement or upgrading in the short term?

#### Settlement Procedures

- If the bank is a member of CHIPS, Fedwire or other clearinghouse system, are procedures inadequate for the proper monitoring of incoming and outgoing wire transfers so that the bank is occasionally unprepared for settlement?
  - Would earnings be significantly affected if the immediate acquisition of funds is required to meet settlement?
  - Is the bank aware of the creditworthiness and ability of the other clearinghouse participants to make settlement?
- Are customers' daylight overdrafts allowed to exceed established credit limits or are they otherwise being improperly monitored?
- Is there a history of daylight overdrafts which have not been covered before the close of business?

#### Investment Securities

- Are there significant internal control deficiencies associated with the bank's handling of "when issued" trades, futures contracts and forward placements?
  - Is management's knowledge of interest rate hedging techniques insufficient to support such activity?
- Does the bank act as agent on securities or repurchase agreement transactions?
  - If so, does the customer agreement specifically designate liability for failure or performance?

## Miscellaneous

- Did the analytical review of income and expenses disclose any additional off balance sheet activities for which management does not exhibit the necessary expertise and does not have adequate internal controls to handle the service?
- Does a review of legal actions against the bank indicate any pattern of practices which are caused by deficient internal controls?
  - If so, have the deficiencies been corrected?
- Is the potential liability arising from pending litigation considered significant in terms of capital adequacy and liquidity, considering the level of other contingent liabilities?
- Are any of the bank's affiliates or subsidiaries experiencing unprofitability or liquidity problems which may affect the soundness of the bank?
- Are operating lease liabilities and annual lease payments significant in terms of the bank's other funding requirements?
- Is potential restitution resulting from Truth in Lending Act violations significant relative to capital and liquidity?
- Is the bank's level of loan commitments, standby letters of credit, commitments to purchase securities and futures/forward contracts imprudent in light of overall circumstances within the bank?

g. *Internal Controls and Audit Procedures*

- Have internal controls deteriorated since the last examination?
- Do any of the following exist at the bank?
  - Low compensation level of internal auditors.
  - Internal or external auditor who reports directly to other than the board of directors or a committee thereof.
  - Internal auditors who perform original work versus monitoring the efforts of others.

- Abnormally low percentage of internal auditors to total personnel.
  - Inadequate training or supervision of internal auditors.
  - Questionable independence of external auditors.
  - Inadequate management response to deficiencies cited by auditors.
- If so, do these or other pertinent factors indicate a less than adequate situation in internal or external audit?
- Are internal controls and audit programs deemed inadequate?

h. *Ownership*

- Have there been significant changes in ownership since the last examination?
  - If so, could the change be detrimental to the soundness of the bank?
- Does any situation exist wherein one individual is capable of controlling the bank?
  - If so, is that detrimental to the bank's soundness?
- Is there any evidence of an impending proxy fight?
- Are ownership interests using borrowed funds to carry the bank's stock?
  - If so, is there an indication that undue pressure for increased earnings is being applied by the owners?
  - If such pressure is being applied, does that have a detrimental impact on the general characteristics of asset composition, as it exists, and asset composition, as it is expected to develop?

i. *Miscellaneous*

- Does the bank exhibit a high dependence on purchasing or participating in loans originated and managed by others?
  - If so, is that attributable to a lack of local loan demand or to a failure of the bank to service its trade area?
- Is there an increasing trend toward making loans and/or accepting deposits from outside of areas in which the bank maintains offices?

- If so, does management and the board fully understand the risks inherent in such activity?
  - Has a trend toward increasing advances to affiliated companies developed?
    - If so, does that presently represent a dangerous situation?
  - Has the bank experienced an abnormally fast rate of growth?
    - If so, is that growth reasonable and does it therefore, have no significant impact on future soundness, based on:
      - Economic conditions within the trade area?
      - The bank's increased marketing efforts?
      - Offering improved services to the community?
      - Other factors?
    - If so, is the bank's management team capable of adequately administering the growth?
  - Does the bank have an imprudent investment in fixed assets?
  - Does the bank depend to an excessive degree on a small, local economy, which is subject to cyclical swings due to local conditions and industries, as opposed to mirroring national economic trends?
    - If so, is that a source of criticism or does it represent a potentially dangerous situation?
  - Are there large fluctuations in the stock price of the bank or its parent?
    - If so, is management unable to discern a cause for such fluctuations?
  - Is management giving inadequate attention to compliance with laws and regulations?
4. Have all questions raised by the UBPR specialist been explored?
  5. Complete workpapers.
  6. Organize general conclusions regarding the present condition of the bank and:
    - a. Correlate plans, projections, forecasts, and budgets with present conditional aspects, area characteristics, and management capability to determine which of the goals the bank has set you believe to be unattainable.
    - b. Project the future condition of the bank based on its present financial condition, the economic expectations of the bank, the quality of management, director supervision and any other relevant factors.
    - c. Formulate recommendations for management to consider when they initiate corrective or preventative action.
  7. Conduct a final summary discussion with management to include:
    - a. Criticisms noted during the examination.
    - b. Conclusions reached about the bank in general.
    - c. Expected future condition:
      - Management's view.
      - Examiner's view.
    - d. Review of other potential problems.
    - e. Planned corrective action:
      - Examiner recommendations.
      - Management commitments.
  8. Update "Management Assessment" conclusion to add any relevant information obtained as a result of procedures performed in this program.
  9. Prepare recommendations for any necessary supervisory action.
  10. Perform the following steps for suspected violations of criminal statutes:
    - a. Determine that a Criminal Referral Form, FR 2230, has been filed, if appropriate.
    - b. Notify the Reserve Bank by telephone immediately if warranted by the type and seriousness of the suspected violation.
    - c. Prepare a separate memorandum to the Reserve Bank containing sufficient detail to be fully informative.
    - d. Prepare brief comments for the confidential section of the report of examination citing the date of the memorandum to the Reserve Bank.
    - e. Segregate, identify, initial and date all appropriate workpapers and transmit them to the Reserve Bank making certain that the workpapers are factual, complete and do not contain expressions of examiner opinion.
  11. Write, in appropriate report form, all comments and conclusions to be included in the confidential section of the examination report.
  12. Update the workpapers with any information that will facilitate future examinations.

### INTRODUCTION

The board of directors plays an essential role in the management of a bank's operations and is directly responsible for the soundness of the bank. As a result, in some cases, it is useful for Federal Reserve examiners and/or officers to meet with boards of directors. These meetings provide examiners with the opportunity to inform directors of examination findings, discuss the bank's plans and prospects with the board, and highlight important supervisory issues, particularly in cases that may require initiation of informal or formal supervisory actions. Meetings with boards of directors also provide examiners with a limited opportunity to ascertain the directors' knowledge of and interest in the bank's operations.

If Federal Reserve examiners believe it is necessary or desirable, they may conduct meetings with directors immediately after the on-site portion of an examination and before an examination report is completed and distributed. Such meetings are particularly encouraged when they can be conducted as part of regularly scheduled board meetings that coincide with the on-site examination.

When a bank is determined to be a problem or has exhibited significant deterioration, Federal Reserve examiners must conduct meetings with the directors. Such meetings require the participation of Federal Reserve officers and are typically conducted after the report of examination has been distributed.

### GENERAL GUIDELINES

Meetings with boards of directors must be tailored to the individual circumstances of each bank, as well as to the Reserve Bank's supervisory objectives. As a result, uniform procedures for the conduct of these meetings cannot be specified. Nonetheless, the following guidelines should be considered when planning and conducting meetings with bank directors.

#### Content of Meetings

When participating in meetings with bank boards, examiners should present only informa-

tion needed by, or relevant to, the directorate. This information varies depending on the bank's circumstances; however, examiners should inform the board of the examiner's assessment of the bank's condition; highlight any deficiencies requiring the board's attention; and solicit the board's views on the bank's condition, operations, and prospects. In addition, examiners should obtain the board's commitment to address promptly the deficiencies identified in the examination. Examiners should encourage inquiries and discussions with the directors to learn more about the directors' roles and performance and to foster a good working relationship with them.

Data supporting the examiner's conclusions and comments should be prepared and presented to board members in a professional manner. Slides, handouts, and other visual aids are encouraged. Comparative figures and ratios from previous and present examinations should be reviewed prior to the meeting, with handouts and visual aids highlighting adverse trends.

#### Outlines for Meetings

Examiners should prepare detailed outlines of each meeting's discussion points and goals. Following is a sample outline that examiners may use as a guide to prepare for meetings with directors. It is not all-inclusive, and examiners should not be limited by its content in developing their own presentations. Generally, comments on these items are warranted when concerns have arisen during the current examination, or when significant changes—positive or negative—have occurred since the last examination.

- I. Introductory remarks by Federal Reserve Bank official or examiner
  - A. Federal Reserve Bank policy regarding board meeting
  - B. Purpose of the meeting
- II. Examiner's presentation
  - A. Duties and responsibilities of directors
    1. Effectively supervise the bank's affairs
    2. Select competent management
    3. Adopt and follow sound, written policies and objectives

4. Avoid self-serving practices
  5. Be informed of the bank's financial condition and management policies
  6. Maintain reasonable capitalization
  7. Observe banking laws and regulations
  - B. Adequacy and effectiveness of policies and procedures
    1. Lending
    2. Investments
    3. Asset/liability management
    4. Personnel
    5. Operations
  - C. Adequacy and accuracy of bank's reporting systems
    1. Reports of the board and committees
    2. Management reports to the board
    3. Management information systems
    4. Regulatory reports
  - D. Condition of the bank/results of the examination
    1. Asset quality
    2. Violations of law, evidence of self-dealing
    3. Capital
    4. Management
    5. Liquidity
    6. Earnings
    7. Internal controls and audit coverage
    8. Future prospects
    9. Relationships with bank holding company
  - E. Required corrective action on problems and board commitment
- III. Summary of overall conclusions
- IV. Questions from the board

## Procedural Issues

In general, meetings with the full board are preferable. In certain cases, however, a Reserve Bank may determine that meeting with a board committee, such as the executive or audit committee, will fulfill the Reserve Bank's supervisory objectives. Any person connected with the bank, such as an attorney, auditor, or holding company representative, may attend the board of directors meeting at which the overall findings and conclusions of the examination are discussed. The attendance of any such party should be noted in the minutes of the meeting. However, the examiner may excuse such persons during any portion of his or her presentation if deemed appropriate. Attendance by

honorary directors to participate in discussions and review the examination report is also permitted.

Generally, at least one member of a Reserve Bank's official staff is expected to represent the Federal Reserve at meetings with directors of banks. However, for meetings with the directors of banks that have less than \$500 million in assets, Reserve Banks are granted the discretion to have senior examination staff represent the Reserve Bank. The participation of Reserve Bank presidents in meetings with directors is left to the discretion of the Reserve Bank.

To the extent possible, meetings with the boards of directors of state member banks should include representatives of the relevant state banking authority. A meeting with the directors of a bank that is owned by a holding company may be held at the same time as a meeting with the directors of the holding company, when appropriate.

Whenever a meeting is held between an examiner and a board, the examiner should prepare written comments on the meeting for examination workpapers.

## MEETINGS WITH BOARDS OF PROBLEM BANKS AND BANKS EXHIBITING SIGNIFICANT DETERIORATION

When an examination reveals that a bank has significant problems, Federal Reserve policy requires that a meeting be held with its board of directors. The policy further requires that a written summary of examination findings—separate from the complete examination report—be distributed to each director in such cases. A senior Reserve Bank official also must participate in communicating and presenting examination findings on problem banks to their boards of directors. This policy's objective is to ensure that each director of a state member bank considered to be a problem or to have a significant weakness clearly understands the nature and dimension of the problems, as well as the joint and several responsibility of the directors to effect correction.

### Criteria Requiring Meetings with Problem Banks

A meeting with the board of directors is to be

held after any full-scope examination in which a state member bank is assigned a CAMELS composite rating of 4 or 5. A meeting is also required if a bank is rated composite 3 and its condition appears to be deteriorating or has shown little improvement since a previous examination in which it received a composite 3 rating. Furthermore, a meeting should be held after a targeted examination if deemed appropriate and desirable by the Reserve Bank. An official of the Reserve Bank and the examiner-in-charge should also meet with a board if any of the following conditions exist:

- The bank is entering into a formal written agreement with the Federal Reserve, a cease-and-desist order is being issued, or the bank is being placed under a memorandum of understanding.
- The bank is already operating under a supervisory action but is in noncompliance with significant provisions or has experienced significant deterioration since the action was initiated.
- Self-serving activities or other unsafe and unsound practices exist in the bank.
- Any other condition or practice that places, or could place, the bank in a seriously weakened or extended condition has been identified during the examination.

### Additional Guidelines

Senior Reserve Bank officials are expected to participate in meetings with the directors of problem banks, with the seniority of the participating official determined by the condition and size of the bank. The larger the organization or the more serious its problems, the more senior the Federal Reserve official should be.

A meeting with the board of directors of a problem or deteriorating bank should include a formal, structured presentation with a clear statement that the bank is considered a “problem institution” or is about to become a problem institution if existing conditions deteriorate. The presentation should further make clear the nature of problems confronting the bank, citing examination findings such as the following:

- deficiencies in capital, asset quality, earnings, or liquidity
- violations of law

- inadequacies in policies, practices, and reporting systems necessary for proper risk management and organizational administration
- lack of well-documented lending, collection, investment, asset/liability management, and risk-management policies or the failure to ensure that such policies are being followed
- failure of management to address previously discussed deficiencies
- lack of reporting systems sufficient to keep senior management and the board of directors fully informed
- failure of the board of directors to ensure the active management of the organization

### MEETINGS WITH BOARDS OF MULTINATIONAL AND MAJOR REGIONAL BANKS

A meeting with the board of directors is required after every full-scope examination of a multinational organization or major regional organization with assets in excess of \$5 billion. Reserve Banks also are encouraged to conduct such meetings after every full-scope examination of a regional bank with assets in excess of \$1 billion.

### MEETINGS WITH BOARDS OF DE NOVO BANKS

After the approval of a membership application, but before a de novo bank is opened, Reserve Bank staff should meet with the full board of directors to discuss applicable statutes, regulations, policies, and supervisory procedures. As with all meetings with directors, the agenda for this meeting should be tailored to the individual circumstances of the bank. At a minimum, the Reserve Bank should apprise the directors of their responsibilities and emphasize their need to adhere to sound operating policies.

### DIRECTOR'S SUMMARY OF EXAMINATION FINDINGS

In addition to the report of examination, Federal Reserve Banks must provide written reports to directors summarizing the examination findings for all banks rated composite 3, 4, or 5, and for those rated composite 1 or 2 that show signs of



significant deterioration in condition or apparent violations of law. The summary reports should focus on identified problems—rather than on the strength of the organization—and present the bank’s deficiencies succinctly and clearly. In all cases, the types of actions directors and management should take to address identified problems should be specifically stated. Directors of institutions rated 4 or 5 are to be told their banks are “problem” institutions that warrant “special supervisory attention.” Directors of banks rated 3 are to be informed that the bank’s condition is “not satisfactory,” that the bank is subject to “more-than-normal supervision,” and that the bank may become a “problem” if weaknesses are not addressed adequately.

Summary reports should emphasize the responsibilities of the directors to ensure that corrective actions are taken to address all deficiencies noted in the pages of the full bank examination report entitled “Matters Requiring Board Attention” and “Examination Conclusions and Comments.” In addition, the organization, style, and content of the summary report

should be similar, if not identical, to the text of these report pages.

Summary reports should be sent directly to the bank’s management for distribution to each director. The transmittal letter to the bank should state the report is a summary of identified problems and contemplated supervisory actions and direct bank management to distribute the summary report to each director. The letter should further instruct each director to read the report, sign the introductory statement attesting to having read the report, and return the report to management. Management should keep copies of the directors’ signed statements on file, but should destroy all but one file copy of the summary report itself.

The summary report must be completed and distributed before any meeting between Reserve Bank officials and the bank’s board of directors, to provide the directors with prior notice of deficiencies to be discussed. Reserve Banks should also make every effort to distribute the complete examination report to management before meeting with a board of directors.

# Meetings with Board of Directors

## Examination Objectives

Effective date March 1984

## Section 5030.2

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1. To foster a better understanding of the respective roles of directors and examiners.
2. To inform the directors of the examination scope and the bank's condition.
3. To obtain information concerning future plans and proposed changes in bank policies that may have significant impact on the future condition of the bank.
4. To reach an agreement on any significant problems.
5. To obtain a commitment to initiate appropriate corrective action.

# Meetings with Board of Directors

## Examination Procedures

Effective date March 1984

## Section 5030.3

1. Inform management that a meeting will be held with the board of directors. State the Federal Reserve Bank's policy and the purpose of the meeting and establish a tentative date.
2. Finalize the time and place of the meeting when confident that a thorough understanding of the condition of the bank will be developed. If the meeting is to be a "special meeting" resulting from serious areas of concern, perform procedure 7.
3. Develop an outline of matters to be covered at the meeting by reviewing results of the examination.
4. Prepare supportive data for the meeting by:
  - a. Compiling a list of comments and criticisms.
  - b. Preparing schedules of comparative figures for discussion.
  - c. Affirming that the bank has responded adequately to Reserve Bank requests.
  - d. Preparing questions to elicit opinions and attitudes of individual board members.
5. Prepare a brief formal agenda for the meeting and reproduce enough copies to distribute to participants.
6. If it is decided that a meeting will be held:
  - a. Communicate with Reserve Bank office to:
    - Notify office staff of the proposed date and place of the meeting. (Confirm time and place when final.)
    - Determine whether a Reserve Bank official will attend.
    - Determine whether the Reserve Bank official has suggestions for the agenda.
  - b. Submit a copy of the agenda and outline in advance to the Reserve Bank official.
  - c. Inform directors that the following must be submitted to the Reserve Bank office:
    - A copy of a board resolution stating corrective action.
    - A written plan for corrective action to be forwarded within a specified time period.
    - Periodic progress reports.
7. For "special meetings" resulting from serious problems:
  - a. Communicate with the Reserve Bank to:
    - Notify office staff of the proposed date and place of the meeting.
    - Determine whether a Reserve Bank official will attend.
    - Determine whether the Reserve Bank official has suggestions for the agenda.
  - b. Confirm the final time and place of the meeting with the Reserve Bank office.
  - c. Prepare any special supporting data for the meeting, such as areas of noncompliance with memorandums of understanding or cease and desist agreements or orders.
8. Conduct the board meeting in accordance with the agenda and previously prepared outline, being certain to discuss:
  - a. Major criticisms noted during the examination.
  - b. Conclusions reached about the bank in general.
  - c. Expected future conditions.
  - d. Potential problems.
  - e. Planned corrective action:
    - Examiner's recommendations.
    - Management's commitments.
    - Director's commitments.
9. Obtain a definite agreement or commitment from the board that appropriate corrective action will be taken.
10. Prepare a memorandum covering the meeting with the board to include, as a minimum:
  - a. The time and place of the meeting.
  - b. The directors and guests in attendance.
  - c. The matters subject to criticism that were reviewed.
  - d. A summary of the general discussion on the matters presented to the board.
  - e. A summary of the director's reaction to the situation and any commitments obtained from them.
11. Request that copies of the minutes of the board meeting be forwarded to the Reserve Bank and the examiner-in-charge.

### INTRODUCTION

The Federal Reserve Board has a broad range of enforcement powers over both domestic and foreign financial institutions and over the individuals associated with them. Generally, formal or informal enforcement actions are taken after the completion of an on-site bank examination. These examinations include commercial, trust, electronic data processing, consumer, or other types of examinations. Formal or informal enforcement actions may also be taken when a Reserve Bank becomes aware of a problem at a bank that warrants immediate attention and correction.

Many of the Board's enforcement powers were initiated or enhanced by title IX of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) and by the Comprehensive Thrift and Bank Fraud Act (Bank Fraud Act).<sup>1</sup> The Board's jurisdiction over individuals associated with financial institutions, that is, "institution-affiliated parties," includes any officer, director, employee, controlling shareholder, or agent of a financial institution, and any other person who has filed or is required to file a change-in-control notice. The term "institution-affiliated party" also includes any shareholder, consultant, joint venture partner, or any other person who participates in the conduct of the affairs of the financial institution, as well as any independent contractors, including attorneys, appraisers, and accountants, who knowingly or recklessly participate in any violation of law or regulation, breach of fiduciary duty, or unsafe or unsound practice that causes (or is likely to cause) more than a minimal financial loss to, or a significant adverse effect on, a financial institution.<sup>2</sup> The Board's jurisdiction over an institution-affiliated party extends for up to six years after the party's resignation, termination of employment, or separation caused by the closing of a financial institution, provided that any notice (such as a notice of intent to

remove from office and of prohibition) is served on the party before the end of a six-year period.

### FORMAL SUPERVISORY ACTIONS

The following statutory tools are available to the Board in the event formal supervisory action is warranted against a state member bank or any institution-affiliated party. The objective of formal action is to correct practices that the regulators believe to be unlawful, unsafe, or unsound.<sup>3</sup> The initial consideration and determination of whether formal action is required usually results from examination findings. It is important to provide adequate workpaper documentation to support all recommendations for both formal and informal actions.

#### Types of Corrective Actions

Generally, under 12 USC 1818, the Board may use its cease-and-desist authority and civil money penalty authority against any state member bank and any institution-affiliated party that meets the statutory criteria for issuing such an order. Prohibition and removal actions may be taken against any institution-affiliated party who meets the statutory criteria to bring such an action.

#### *Cease-and-Desist Orders*

Generally, under 12 USC 1818(b), the Board may use its cease-and-desist authority against a state member bank and any institution-affiliated party when it finds that a bank or party is engaging, has engaged, or is about to engage in (1) a violation of law, rule, or regulation; (2) a violation of a condition imposed in writing by the Board in connection with the granting of any application or any written agreement; or (3) an unsafe or unsound practice in conducting the business of the institution. Under 12 USC

1. The Financial Institutions Reform, Recovery, and Enforcement Act was enacted on August 9, 1989; the Comprehensive Thrift and Bank Fraud Act was enacted on November 27, 1990.

2. The Board is authorized to issue regulations further defining which individuals should be considered institution-affiliated parties. Similarly, the Board may determine whether an individual is an institution-affiliated party on a case-by-case basis. (See 12 USC 1813(u).)

3. An unsafe or unsound practice is defined as any action that is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance fund.

1818(s), the Board must initiate a cease-and-desist action against a bank when it has failed to establish Bank Secrecy Act procedures required by the Board's Regulation H or has failed to correct any previously noted deficiencies related to these procedures.

A cease-and-desist order may require the bank or person subject to the order to (1) cease and desist from the practices or violations or (2) take affirmative action to correct the violations or practices. Affirmative actions might include returning the bank to its "original condition" before the practice or violation. Affirmative actions may also include restrictions on growth, debt, and dividends; the disposition of any loan or asset; rescission of agreements or contracts; employment of qualified officers or employees; restitution, reimbursement, indemnification, or guarantee against loss if the bank or person was unjustly enriched by the violation or practice, or if the violation or practice involved a reckless disregard for the law or applicable regulations or a prior order; and any other action the Board determines to be appropriate.

When Board staff, in conjunction with the appropriate Reserve Bank, determine that a cease-and-desist action is necessary, the bank or person is generally given an opportunity to consent to the issuance of a cease-and-desist order without the need for the issuance of a notice of charges and a contested administrative hearing. Generally, Board staff draft a proposed cease-and-desist order and, with Reserve Bank staff, present it to the bank or individual for consent before submitting the case to the Board. Banks or individuals are advised that they may have legal counsel present at all meetings with Board or Reserve Bank staff concerning formal corrective actions. If the parties voluntarily agree to settle the case by the issuance of a consent cease-and-desist order, the proposed consent order will be presented to Board officials for ratification and formal issuance of the order, at which time the order will be final and binding.

When a bank or person fails to consent to a cease-and-desist order, the Board may issue a notice of charges and of hearing to the bank or party. The notice of charges contains a detailed statement describing the facts constituting the alleged violations or unsafe or unsound practices. The issuance of the notice of charges and of hearing starts a formal process that includes the convening of a public administrative hear-

ing<sup>4</sup> conducted before an administrative law judge, appointed by the Board. After the hearing, the judge makes a recommended decision to the Board. A hearing must be held within 30 to 60 days of service of the notice of charges, unless a later date is set by the administrative law judge. After the Board considers the record of the proceeding, including the administrative law judge's recommended decision, it determines whether to issue a final cease-and-desist order. Banks and individuals who are subject to cease-and-desist orders that were issued as a result of contested proceedings may appeal the order to the appropriate federal court of appeals.

### *Temporary Cease-and-Desist Orders*

If a violation or threatened violation of law, rule, or regulation, or if engagement in an unsafe or unsound practice specified in the notice of charges, is likely to cause the bank's insolvency, cause significant dissipation of the bank's assets or earnings, weaken the bank's condition, or otherwise prejudice the interests of depositors before the completion of the proceedings (initiated by the issuance of the notice of charges), the Board may, in conjunction with issuing a notice of charges, issue a temporary cease-and-desist order against the bank or any institution-affiliated party to effect immediate correction (pursuant to 12 USC 1818(c)). The Board may also issue a temporary order if it determines that the bank's books and records are so incomplete or inaccurate that the Board is unable to determine, through the normal supervisory process, the bank's financial condition or the details or purpose of any transaction that may have a material effect on its condition. The temporary order may require the same corrections as a formal cease-and-desist order. The advantage of issuing a temporary cease-and-desist order is that it becomes effective immediately after it is served on the entity or individual. Within 10 days after being served with a temporary order, however, the entity or individual may appeal to a U.S. district court for relief from the order. Unless set aside by the district court, the temporary order stays in effect until the Board issues a final cease-and-desist order or dismisses the action.

4. A private hearing may be held if the Board determines that holding a public hearing would be contrary to the public interest.

### Written Agreements

When circumstances warrant a less severe form of formal supervisory action, a written agreement may be used. A written agreement may be with either the Board or with the Reserve Bank under delegated authority (12 CFR 265.11(a)(15)). All written agreements must be approved by the Board's director of the Division of Banking Supervision and Regulation and the general counsel. The provisions of a written agreement may relate to any of the problems found at the bank or to any problems involving institution-affiliated parties.

### Prohibition and Removal Authority

The Board is authorized by 12 USC 1818(e) to remove any current institution-affiliated party of a bank for certain violations and misconduct and to prohibit permanently from the banking industry any current or former institution-affiliated party from future involvement with any insured depository institution, bank or thrift holding company, and nonbank subsidiary.<sup>5</sup>

The Board is authorized to initiate removal or prohibition actions when—

- the institution-affiliated party has directly or indirectly—
  - violated any law, regulation, cease-and-desist order, condition imposed in writing, or written agreement;
  - engaged in any unsafe or unsound practice; or
  - breached a fiduciary duty;
- the Board determines that, because of the violation, unsafe or unsound practice, or breach—
  - the institution has suffered or will probably suffer financial loss or other damage;
  - the interests of depositors have been or could be prejudiced by the violation, practice, or breach; or
  - the institution-affiliated party has received financial gain or other benefit from the violation, practice, or breach; and
- the violation, practice, or breach—
  - involves personal dishonesty or

- demonstrates a willful or continuing disregard for the safety or soundness of the institution.

The statute also authorizes the Board to initiate removal or prohibition actions against (1) any institution-affiliated party who has committed a violation of any provision of the Bank Secrecy Act that was not inadvertent or unintentional, (2) any officer or director of a bank who has knowledge that an institution-affiliated party has violated the money-laundering statutes and did not take appropriate action to stop or prevent the reoccurrence of such a violation, or (3) any officer or director of a bank who violates the prohibitions on management interlocks. These removal or prohibition actions do not require a finding of gain to the individual, loss to the institution, personal dishonesty, or willful or continuing disregard for the safety or soundness of the institution.<sup>6</sup> Like a cease-and-desist order, a removal or prohibition order may be issued either by consent or after an administrative process initiated by the issuance of a notice of intent to remove and prohibit.

If an institution-affiliated party's actions warrant immediate removal from a state member bank, the Board is authorized to suspend the person temporarily from that bank pending the outcome of the complete administrative process. An institution-affiliated party presently associated with a bank may also be suspended or removed for cause based on actions taken while formerly associated with a different insured depository institution, bank holding company, or "business institution." Business institution is not specifically defined in the statute so that it may be interpreted to include any other business interests of the institution-affiliated party.

Under 12 USC 1818(g), the Board is authorized to suspend from office or prohibit from further participation any institution-affiliated party charged or indicted for the commission of a crime involving personal dishonesty or breach of trust that is punishable by imprisonment for a term exceeding one year under state or federal law, if the continued participation might threaten either the interests of depositors or public confidence in the bank. The Board may also suspend or prohibit any individual charged with a violation of the money-laundering statutes. The suspension can remain in effect until the criminal action is disposed of or until the suspension

5. This authority is distinct from the Board's authority under prompt corrective action to dismiss senior officers from a particular bank.

6. See 12 USC 1818(e)(2).

is terminated by the Board. The Board may also initiate a removal or prohibition action against an institution-affiliated party who has been convicted of, or pleaded to, a crime involving personal dishonesty or breach of trust if his or her continued service would threaten the interests of the depositor or impair public confidence in the institution. The Board is required to issue such an order against any institution-affiliated party who has been convicted of, or pleaded to, a violation of the money-laundering statutes.

Furthermore, 12 USC 1829 prohibits any individual who has been convicted of a crime involving dishonesty, breach of trust, or money laundering from (1) serving as an institution-affiliated party of, (2) directly or indirectly participating in the affairs of, and (3) owning or controlling, directly or indirectly, an insured depository institution without the FDIC's prior approval. Under certain circumstances, the statute also prohibits a convicted person from holding a position at a bank holding company or nonbank affiliate of a bank without the FDIC's prior approval. The penalty for violation of this law is a potential fine for a knowing violation of up to \$1 million per day, imprisonment for up to five years, or both. The criminal penalty applies to both the individual and the employing institution.

## Violations of Final Orders and Written Agreements

When any final order or temporary cease-and-desist order has been violated, the Board may apply to a U.S. district court for enforcement of the action. The court may order and require compliance.

Violations of final orders and written agreements may also give rise to the assessment of civil money penalties against the offending bank or institution-affiliated party, as circumstances warrant. The civil money penalty is assessed in the same manner as described in the "Civil Money Penalties" subsection below. Any institution-affiliated party who violates a suspension or removal order is subject to a criminal fine of up to \$1 million, imprisonment for up to five years, or both.

## Civil Money Penalties

The Board may assess civil money penalties of up to \$5,000 per day against any institution or

institution-affiliated party for any violation of (1) law or regulation; (2) a final cease-and-desist, temporary cease-and-desist, suspension, removal, or prohibition order or for failure to comply with a prompt-corrective-action-directive;<sup>7</sup> (3) a condition imposed in writing by the Board in connection with the granting of an application or other request; and (4) a written agreement.

A fine of up to \$25,000 per day can be assessed for a violation, an unsafe or unsound practice recklessly engaged in, or a breach of fiduciary duty when the violation, practice, or breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss to the bank, or results in pecuniary gain or other benefit for the offender. A civil money penalty of up to \$1 million per day can be assessed for any knowing violation, unsafe or unsound practice, or breach of any fiduciary duty when the offender knowingly or recklessly caused a substantial loss to the financial institution or received a substantial pecuniary gain or other benefit. Civil money penalties may also be assessed, under the three-tier penalty framework described above, for any violation of the Change in Bank Control Act and for violations of the anti-tying provisions of federal banking law, among other provisions.<sup>8</sup>

The Board may also assess civil money penalties for the submission of any late, false, or misleading call reports. If a financial institution maintains procedures that are reasonably adapted to avoid inadvertent errors, but unintentionally fails to publish any report, submits any false or misleading report or information, or is minimally late with the report, it can be assessed a fine of up to \$2,000 per day. The financial institution has the burden of proving that the error was inadvertent under these circumstances. If the error was not inadvertent or the bank lacked the appropriate procedures, a penalty of up to \$20,000 per day can be assessed for all false or misleading reports or information submitted to the Board. If the submission was

7. Prompt-corrective-action directives may be enforced in the federal courts, and they may cause any bank, company, or bank-affiliated party that violates the directive to be subject to civil money penalties. The failure of a bank to implement a capital-restoration plan, or the failure of a company having control of a state member bank to fulfill a guarantee that the company has given in connection with a capital plan accepted by the Federal Reserve, could subject the bank or company or any of their bank-affiliated parties to a civil money penalty assessment. (See section 4133.1.)

8. See 12 USC 1972.

done in a knowing manner or with reckless disregard for the law, a fine of up to \$1 million or 1 percent of the institution's assets, whichever is less, can be assessed for each day of the violation. Under its general civil money penalty authority, the Board may also assess civil money penalties against any institution-affiliated party who participates in a bank's filing of late, false, or misleading call reports.

## Administration of Formal Actions

### *Publication of Final Orders*

Under 12 USC 1818(u), the Board is required to publish and make publicly available any final order issued for any administrative enforcement proceeding it initiates. These orders include cease-and-desist, removal, prohibition, and civil money penalties. The Board is also required to publish and make publicly available any written agreement or other written statement that it may enforce, unless the Board determines that publication would be contrary to the public interest.

### *Public Hearings*

Under 12 USC 1818(u), all formal hearings, including contested cease-and-desist, removal, and civil money penalty proceedings, are open to the public unless the Board determines that a public hearing would be contrary to the public interest. Transcripts of all testimony; copies of all documents submitted as evidence in the hearing, which could include examination or inspection reports and supporting documents (except those filed under seal); and all other documents, such as the notice and the administrative law judge's recommended decision, are available to the public.

### *Appointment of Directors and Senior Executive Officers*

Under section 32 of the Federal Deposit Insurance Act (12 USC 1831i) and subpart H of Regulation Y (12 CFR 225.71 et seq.), any state member bank or bank holding company that is in a troubled condition<sup>9</sup> or does not meet mini-

imum capital standards must provide 30 days' written notice to the Board of Governors before appointing any new director or senior executive officer.<sup>10</sup> This requirement also applies to any change in the responsibilities of any current senior executive officer who is proposing to assume a different senior officer position. Subpart H of Regulation Y details the procedures for filing and the content of the notice. The Board may disapprove a notice if it finds that the competence, experience, character, or integrity of the proposed individual indicates that his or her service would not be in the best interest of the institution's depositors or the public. A disapproved individual or the institution that filed the notice may appeal the Federal Reserve's notice of disapproval under the procedures detailed in Regulation Y. The individual may not serve as a director or senior executive officer while the appeal is pending. In the event that a state member bank or bank holding company that is in a troubled condition appoints a director or senior officer without the required 30 days' prior written notice, appropriate follow-up supervisory action should be taken.

### *Interagency Notification*

Under interagency agreements, any federal banking regulatory agency that proposes to take a formal enforcement action (such as a cease-and-desist order, civil money penalty, or removal) must notify the other federal financial institution regulatory agencies (including the OTS) of the action. For informal enforcement actions, such as memoranda of understanding, notifications must be made when there is an affiliation or interinstitution relationship. Notifications are to be made to a designated contact person specified by each agency. To foster federal-state agency coordination, the Federal Reserve provides the appropriate state supervisory authority with

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condition if it (1) has a composite rating, determined at its most recent examination, of 4 or 5; (2) is subject to a cease-and-desist order or formal written agreement that requires action to improve the bank's financial condition; or (3) is expressly informed by the Board or Reserve Bank that it is in troubled condition.

10. The Board or Reserve Bank may permit, under extraordinary circumstances, an individual to serve as a director or senior executive officer before a notice is provided; however, this permission does not affect the Federal Reserve's authority to disapprove a notice within 30 days of its filing. The Board may extend the review period to a maximum of 90 days if needed to process the notice.

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9. As defined in section 225.71 of the Board's Regulation Y, a state member bank or holding company is in troubled



notice of its intent to institute a formal corrective action against a bank or its institution-affiliated parties, pursuant to 12 USC 1818(m).<sup>11</sup>

## INFORMAL SUPERVISORY ACTIONS

Informal supervisory tools are used when circumstances warrant a less severe form of action than the formal supervisory actions described above. Informal actions are not enforceable, and their violation cannot serve as a basis for assessing a civil money penalty or initiating a removal and prohibition action. Informal actions are not published or publicly available. These informal actions include the following:

- *Commitments* are generally used to correct minor problems or to request periodic reports addressing certain aspects of a bank's operations. Commitments may be used when there are no significant violations of law or unsafe or unsound practices and when the bank and its officers and directors are expected to cooperate and comply.<sup>12</sup> Commitments are generally obtained by the Reserve Bank's sending a letter to the bank outlining the request and asking for a response and an indication that the commitments are accepted.
- *Board resolutions* generally represent a number of commitments made by the bank's directors and are incorporated into the bank's corporate minutes. The Reserve Bank may request board resolutions in the examination transmittal letter, which asks the bank to provide it with a signed copy of the corporate resolution.
- *Memoranda of understanding (MOU)* are highly structured written, but informal, agreements that are signed by both the Reserve Bank and the bank's board of directors. An MOU is generally used when a bank has multiple deficiencies that the Reserve Bank believes can be corrected by the present man-

agement. Although an informal action, imposition of an MOU may require disclosure to the Securities and Exchange Commission and to the bank's liability bond issuer.

## INDEMNIFICATION PAYMENTS AND GOLDEN PARACHUTE PAYMENTS

In general, an indemnification payment is a payment that reimburses an insider for a specified liability or cost that the person incurred (for example, a bank might indemnify a director for the cost of legal fees or even, theoretically, penalties in connection with a Federal Reserve investigation or enforcement action). Golden parachute payments are severance payments or agreements to make severance payments that are paid or entered into at a time when the bank or holding company is in a troubled condition. These payments require the prior written approval of the institution's primary regulator and the FDIC. A golden parachute payment may include a glorified severance payment to a former insider that is paid under specified circumstances. Although both types of payments fall under the same statute, section 18(k) of the Federal Deposit Insurance Act (the FDI Act) (12 USC 1828(k)), the two types of payments are quite different and distinct. However, some of the restrictions on these payments are the same or similar.

### Indemnification Agreements and Payments

State member banks may seek to indemnify their officers, directors, and employees from any judgments, fines, claims, or settlements, whether civil, criminal, or administrative. The bylaws of some state member banks may have broadly worded indemnification provisions, or the bank may have entered into separate indemnification agreements that cover the ongoing activities of its own institution-affiliated parties. Such indemnification provisions may be inconsistent with federal banking law and regulations, as well as with safe and sound banking practices.

Supervisory and examiner staff should be alert to the limitations and prohibitions on indemnification imposed by section 18(k) of the

11. The procedures for notification to state agencies and other federal banking regulatory agencies are outlined in SR-97-5, "Policy Statement on Interagency Notification and Coordination of Enforcement Action."

12. Informal commitments are distinct from conditions imposed in writing in connection with the grant of an application or other request by an institution, which may be enforced through the imposition of a civil money penalty.

FDI Act<sup>13</sup> and the regulations issued thereunder by the FDIC. The law and regulations apply to indemnification agreements and payments made by any bank to any institution-affiliated party, regardless of the condition of the financial institution. The purpose of the law and regulations is to preserve the deterrent effects of administrative enforcement actions (by ensuring that individuals subject to final enforcement actions bear the costs of any judgments, fines, and associated legal expenses) and to safeguard the assets of financial institutions.

A prohibited indemnification payment includes any payment (or agreement to make a payment) by a bank to an institution-affiliated party to pay or reimburse such person for any liability or legal expense in any federal banking agency administrative proceeding that results in a final order or settlement in which the institution-affiliated party is assessed a civil money penalty, is removed or prohibited from banking, or is required to cease an action or take any affirmative action, including making restitution, with respect to the bank.<sup>14</sup> In cases in which the institution-affiliated party prevails, the institution can make a payment if the board of directors determines that it is in the best interest of the institution and the payment does not materially adversely affect the institution's safety and soundness.

The law and the FDIC's regulations apply to all state member banks. They reinforce the Federal Reserve's longstanding policy that an institution-affiliated party who engages in misconduct *should not* be insulated from the consequences of his or her misconduct. From a safety-and-soundness perspective, a state member bank should not divert its assets to pay a fine or other final judgment issued against an institution-affiliated party for misconduct that presumably violates the bank's policy of compliance with applicable law, especially in cases where the individual's misconduct has already harmed the bank.

State member banks should review their bylaws and any outstanding indemnification agreements, as well as insurance policies, to ensure that they conform with the requirements of federal law and regulations. If a state member bank fails to take appropriate action to bring its indemnification provisions into compliance with federal laws and regulations, appropriate

follow-up supervisory action may be taken. As part of the supervisory process, which will include merger and acquisition applications, the Federal Reserve's supervisory and examiner staff will review identified agreements having indemnification-related issues for compliance with federal law and regulations. (See SR-02-17.)

## Golden Parachute Payments

"Golden parachute" payment restrictions were enacted as part of the Crime Control Act of 1990.<sup>15</sup> The law added section 18(k) to the Federal Deposit Insurance Act (12 USC 1828(k)) and authorized the FDIC to issue implementing regulations. The FDIC's golden parachute regulations may apply to an insured depository institution if the institution is in a troubled condition as defined in Regulation Y. The purposes of the law and regulations include safeguarding the assets of financial institutions and limiting rewards to institution-affiliated parties who may have contributed to the institution's condition.

In general, the FDIC's regulations prohibit insured depository institutions and their holding companies from making golden parachute payments except in certain circumstances.<sup>16</sup> A golden parachute payment means any payment in the nature of compensation (or agreement to make such a payment) for the benefit of any current or former institution-affiliated party of an insured depository institution or its holding company that meets three criteria. First, the payment or agreement must be contingent on the termination of the institution-affiliated party's employment or association. Second, the payment or agreement is received on or after, or made in contemplation of, among other things, a determination that the institution or holding company is in a troubled condition under the regulations of the applicable banking agency. Third, the payment or agreement must be payable to an institution-affiliated party who is terminated when the institution or holding company meets certain specific conditions, including being subject to a determination that it is in a troubled condition.

15. SR-90-38 generally describes the provisions of the Crime Control Act of 1990.

16. See the FDIC's golden parachute regulations in 12 CFR 359.

13. See 12 USC 1828(k).

14. See 12 CFR 359.

The definition of a golden parachute payment also covers a payment made by a bank holding company that is not in a troubled condition to an institution-affiliated party of an insured depository institution subsidiary that is in a troubled condition, if the other criteria in the definition are met. This circumstance may arise when a bank holding company, as part of an agreement to acquire a troubled bank or savings association, proposes to make payments to the troubled institution's institution-affiliated parties that are conditioned on their termination of employment.<sup>17</sup>

A state member bank or bank holding company may make or enter into an agreement to make a golden parachute payment only (1) if the Federal Reserve, with the written concurrence of the FDIC, determines that the payment or agreement is permissible; (2) as part of an agreement to hire competent management in certain conditions, with the consent of the Federal Reserve and the FDIC as to the amount and terms of the proposed payment; or (3) pursuant to an agreement to provide a reasonable severance not to exceed 12 months' salary in the event of an unassisted change in control of the depository institution, with the consent of the Federal Reserve. In determining the permissibility of the payment, the Federal Reserve may consider a variety of factors, including the individual's degree of managerial responsibilities and length of service, the reasonableness of the payment, and any other factors or circumstances that would indicate that the proposed payment would

be contrary to the purposes of the statute or regulations.

A state member bank or bank holding company requesting approval to make a golden parachute payment or enter into an agreement to make such a payment should submit its request simultaneously to the appropriate FDIC regional office and Federal Reserve Bank. The request must detail the proposed payments and demonstrate that the state member bank or bank holding company does not possess and is not aware of any evidence that there is reasonable basis to believe, at the time that the payment is proposed to be made, that the institution-affiliated party receiving such a payment has committed any fraud, breach of fiduciary duty, or insider abuse or has materially violated any applicable banking law or regulation that had or is likely to have a material adverse effect on the bank or company; that the individual is substantially responsible for the institution's insolvency or troubled condition; and that the individual has violated specified banking or criminal laws.

If a state member bank or bank holding company makes or enters into an agreement to make a golden parachute payment without prior regulatory approval when such an approval is required, appropriate follow-up supervisory action should be taken. This follow-up could include an enforcement action requiring the offending institution-affiliated party to reimburse the institution for the amount of the prohibited payment. When state member banks or bank holding companies are identified as having golden parachute-related issues in the supervisory process, those issues should be carefully reviewed for compliance with the law and the FDIC's regulations. The appropriate Reserve Bank supervisory staff and the appropriate staff of the Board's Division of Banking Supervision and Regulation should be notified and consulted on the golden parachute-related issues. (See SR-03-06.)

17. The FDIC's regulations exclude from the definition of a golden parachute payment several types of payments, such as payments made pursuant to a qualified pension or retirement plan; a benefit plan or bona fide deferred compensation plan (which are further defined in the FDIC's regulations); or a severance plan that provides benefits to all eligible employees, does not exceed the base compensation paid over the preceding 12 months, and otherwise meets the regulatory definition of nondiscriminatory and other conditions in the FDIC's regulations.

The Commercial Bank Report of Examination was made available for use by the Federal Reserve System. The report is also available for use by state banking departments in their examinations of state-chartered institutions.

Certain report pages are mandatory for all full-scope bank examination reports prepared by Federal Reserve examiners. Some of the pages are required that address the examiner's conclusions and provide information on capital, asset quality, management, earnings, liquidity, and sensitivity to market risk (CAMELS). Headings on specific report pages for the examiner's assessment of specific CAMELS components provide a series of considerations for the examiner to address in the evaluation of each component. The Federal Reserve has designated other pages as optional.

The instructions reflect the examiners' use of certain content (section) headings for an optional continuous flow reporting format, and the use of the above-mentioned required report pages or sections. The Commercial Bank Examination Report may continue to consist of specific or individual report "pages." This section will provide the examiner with guidance on both when to include certain report pages in the report and how to prepare required and optional report pages. Instructions for optional pages describe situations that warrant their inclusion in full-scope Federal Reserve reports.

## FEDERAL RESERVE SYSTEM REPORT INSTRUCTIONS

The following instructions provide general guidance to the examiner in evaluating certain aspects of a bank's operations and in completing the report; they are neither intended to constitute a technical manual on conducting examinations and completing reports nor are they designed to set forth all of the factors, considerations, and issues that examiners must address and evaluate when they conduct examinations. In addition, these instructions are not intended to address legal and compliance questions; rather, examiners should consult the appropriate laws, regulations, and examiner guidelines. Questions on completing the report that are not covered by these instructions should be referred to Reserve Bank management or Board staff.

Instructions for specific pages follow in the order recommended for their inclusion in full-scope examination reports. The header at the top of each section of instructions indicates whether the report page is mandatory or optional.

The instructions and report-page formats do not provide for the use of peer-group data for analytical purposes. The Federal Reserve System advocates the use of peer-group data for financial analysis. Examiners should routinely consider using peer information in report narratives or in charts and tables within narratives to support their conclusions. Comparisons to subsets of the national peer group may also be meaningful. If the examiner uses other than national UBPR peer information for comparison purposes, the substitute peer group should be clearly identified.

## Communication of Examination Findings

An important part of the examination of banking organizations is the communication of findings to the directors and senior management. Examination findings may be communicated in writing through formal reports, through letters summarizing the results of targeted reviews or a roll-up (consolidation) of those reviews or through some combination thereof, depending upon the size and complexity of the organization. These written communications are generally directed to the board of directors, an executive-level committee, or senior management, as appropriate.

To be effective, the communication of examination findings must be (1) written in clear and concise language, (2) prioritized based upon importance, and (3) focused on any significant matters that require attention. In addition, written communications to a board of directors should clarify whether the action must be taken directly by the board or whether the action may be delegated by the board even though the board would continue to be held accountable.

To improve the consistency and clarity of written communications, the Federal Reserve uses standardized terminology to differentiate among

- *Matters Requiring Immediate Attention*, matters arising from the examination that the

Federal Reserve is requiring a banking organization to address immediately;

- *Matters Requiring Attention*, matters that are important and that the Federal Reserve is expecting a banking organization to address over time; and
- *Observations*, matters that are informative, advisory, or suggest a means of improving performance or management of the operations of the organization.

*Matters Requiring Immediate Attention* (MRIA) encompass the highest priority concerns and include matters that have the potential to pose significant risk to the organization's safety and soundness or that represent significant instances of noncompliance with laws and regulations. These concerns must be addressed immediately by the board of directors or senior management. The action required to address the concern may be a single, short-term event, such as injecting capital, or it may involve the development of an action plan with remedial actions identified within a specified timeframe. All MRIs must specify a timeframe for completion. The key element is that action to address the concern must begin immediately.

*Matters Requiring Attention* (MRA) have a lower priority than MRIs, but nonetheless are matters that, based upon current information, must be addressed over time to preclude a significant issue. While issues giving rise to MRAs must be addressed to ensure the long-term operation of the organization in a safe and sound and compliant manner, the threat to safety and soundness is less immediate than with issues giving rise to MRIs. Nevertheless, communications must also specify a timeframe for MRAs. At least initially, the supervisory team or the institution (when appropriate) may set an imprecise timeframe because the organization may first need to complete preliminary planning. Timeframes for MRAs are likely to become more precise over time or as circumstances change. The key distinction between MRIs and MRAs is the immediacy with which the board of directors or senior management must begin and accomplish remediation.<sup>1</sup>

1. For examples and more information on the use of the terms: *Matters Requiring Immediate Attention*, *Matters Requiring Attention*, and *Observations*, see SR-08-01, and in particular, its attachment.

Reserve Banks must formally communicate MRIs and MRAs to the organization in writing through an examination report or a letter summarizing the results of a target review or a roll-up of such reviews. When included in a safety and soundness examination report, MRIs and MRAs should be noted on the page discussing *Matters Requiring Attention*. In the case of findings from consumer compliance examinations, MRIs and MRAs should be reflected in the Executive Summary and Examination Ratings section of the Consumer Affairs Report of Examination.

*Observations* may be communicated within the body of the reports or conveyed informally to the organization. For example, *Observations* related to enhancement to funds-management policies or practices could be included in the segment on Liquidity Risk Management or discussed with appropriate management personnel.

Communications must specify a timeframe in which the banking organization must complete the action. The expected timeframe for addressing MRIs is generally short, and may be "immediate." In the case of safety-and-soundness findings, corrective actions should be completed within an examination cycle. Supervisory staff should work with senior bank management on the timeframe; however, safety and soundness compliance risk concerns will remain a priority. For MRIs that are necessary to preserve or restore the viability of a banking organization, the timeframe should take into account potential loss to the Federal Deposit Insurance Corporation and whether a delay in action will increase the potential for loss or the cost of resolution.

Communications must also specify a timeframe for MRAs. The timeframe, at least initially, may be imprecise because the organization may first need to complete preliminary planning. The supervisory team may establish the timeframe; however, in some instances, it may be appropriate to request that the institution set forth a reasonable timeframe, subject to supervisory staff concurrence. Timeframes for MRAs are likely to become more precise over time or as circumstances change. Timeframes that span more than one examination cycle for safety-and-soundness issues should include precise or estimated interim targets or thresholds.

Reserve Banks are encouraged to include descriptions of the three categories of findings in

the document communicating findings.<sup>2</sup> Regardless of whether a finding is an MRIA or MRA, the communication should be clear as to whether the board of directors or senior management is accountable for implementing remedial action.

## Combined Reports

Reserve Banks may issue a combined report for a bank holding company and its lead state member bank subsidiary when (1) a bank holding company's lead bank subsidiary is a state member bank and (2) the holding company's board formally approves the release of a combined report to its lead state member bank subsidiary. In cases where the company has more than one state member bank, separate examination reports should be prepared for all other state member bank subsidiaries. At a minimum, a combined report will contain all examination report pages or sections as well as information on the parent company, its subsidiaries, and the consolidated organization. (See SR-94-46 and its attachment.)

The Reserve Bank should send a letter to a qualified holding company that explains its option of receiving a combined report. If the holding company's board wishes to receive a combined report, it should formally approve the release of the combined report to its lead state member bank subsidiary by board resolution.

## General Instructions for Financial Information

The following terms are used on many report pages containing financial information. Guidance on the requirements and options available for each term is provided here.

*Examination Date (or Exam Date).* The date of the financial data used for the examination activity or the ending date of the period reviewed. If the date of the asset-quality review is different from the exam date, any required use of "exam date" in connection with asset quality

should refer to the date of the asset-quality review.

*Period Ended.* No specific timeframe is designated. These columns reflect information for a time period deemed most appropriate by the examiner to support conclusions presented in the Report of Examination. For comparative purposes, this column may reflect financial data from the same period of the prior year as the examination date, the prior quarter, or the most recent year-end.

The examiner-in-charge is responsible for selecting dates deemed most appropriate to present the examination findings. All amounts should be consistent with instructions for the FFIEC Consolidated Reports of Condition and Income (Call Report). If Call Report amendments have been made, the amended numbers should appear. If a bank's management has made any significant misclassifications that have caused examiners to amend any financial statements, the examiners' numbers should be shown in the report and used to calculate any ratios used in the report. Columns titled "Period Ended" should usually detail previous year-end information. However, the examiner may substitute different dates, such as those of the previous examination, when desired. Ratios should generally be computed according to the instructions in the FFIEC's User's Guide to the Uniform Bank Performance Report. Care should be taken in computing all ratios to ensure that ratios are accurate and consistent throughout the report.

## Federal Reserve Examination Report Page List

The following table lists the Federal Reserve's report pages in the order in which they would usually appear, along with a notation of whether their inclusion in the report is mandatory or optional.

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2. With respect to an examination report, this description could be included on the Scope page, in a page of the Appendix, as a footnote on the page discussing Matters Requiring Attention, or elsewhere as the Reserve Bank determines is appropriate.

*Mandatory/  
Optional*

*Report Page or Section Title*

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OPEN SECTION

Mandatory	Table of Contents
Mandatory	Scope
Mandatory	Matters Requiring Board Attention
Mandatory	Examination Conclusions and Comments
Optional*	Compliance with Enforcement Actions
Mandatory	Comparative Statements of Financial Condition
Mandatory	Capital Adequacy
Mandatory	Capital Calculations
Mandatory	Asset Quality
Mandatory	Summary of Items Subject to Adverse Classification/Summary of Items Listed as Special Mention
Mandatory	Loans and Lease-Financing Receivables/Past-Due and Nonaccrual Loans and Leases
Mandatory	Management/Administration
Mandatory	Violations of Laws and Regulations
Mandatory	Earnings
Mandatory	Analysis of Earnings
Mandatory	Liquidity/Asset Liability Management
Mandatory	Sensitivity to Market Risk
Optional	Other Matters
Optional	Concentrations
Optional*	Items Subject to Adverse Classification
Optional*	Items Listed for Special Mention
Optional	Assets with Credit-Data or Collateral-Documentation Exceptions
Mandatory	Signature of Directors

CONFIDENTIAL SECTION

Mandatory	Directors
Mandatory	Executive Officers
Mandatory	Management and Control
Mandatory	Ratings and General Information

\* Some optional pages or sections are mandatory if the circumstances relevant to the page apply. For example, "Compliance with Enforcement Actions" is mandatory if the

bank is subject to corrective action. Optional pages to list classified and special-mention assets are mandatory if items are classified or special mentioned.

These pages or sections may be augmented with supplemental information as needed or required by the Federal Reserve System. Additional supporting schedules and visual aids (for example, graphs and charts) may also be included in the report to communicate and support the examiner's findings.

## Sample Report Pages

Samples of most of the report pages or sections are provided. Because each Reserve Bank may use different methods for preparing the report, differences in typographic styles may exist

between the pages presented here and those at any particular Reserve Bank.

Several report pages or sections are blank except for the title, allowing the examiner almost total discretion in choosing how to present the information. Samples of these report pages are not included, although instructions for their use are. Report pages for which samples are not included are

- Scope
- Matters Requiring Board Attention
- Compliance with Enforcement Actions
- Violations of Laws and Regulations
- Other Matters
- Concentrations

## REPORT PREPARATION INSTRUCTIONS

### Table of Contents (Mandatory)

The table of contents indicates the pages or sections included in full-scope reports. All mandatory pages are to be included in each full-scope Federal Reserve bank examination report. Optional pages or sections will be added to the report as necessary in the order outlined herein, followed by the mandatory Signature of Directors page. Additional supplemental pages or sections to support examiner findings may also be added to the report at the examiner's discretion.

Page numbers are included only for the sake of completeness. The actual page-numbering system used may vary among Reserve Banks.

### Scope (Mandatory)

The Scope page or section is used to list areas reviewed during the examination and describes the extent of those reviews. The examiner should generally address the following:

- the date of examination (commencement and conclusion)
- the type of examination (full-scope, targeted, joint, concurrent, combined (bank holding company and bank))
- the agency or agencies conducting the examination
- areas reviewed and analyzed (If the examina-

tion is targeted, the examiner should identify specific areas reviewed.)

- the percentage and type of loans reviewed
- a confirmation that examination results were discussed with the organization and a list of those attending the meeting
- identification of the bank's peer group
- if necessary, recognition that the bank is operating under a formal or informal supervisory action (If so, state that the provisions of the action were reviewed and compliance was assessed.)

### Matters Requiring Board Attention (Mandatory)

The Matters Requiring Board Attention page or section is used to inform the bank's board of directors of the most significant issues identified during the examination. It should summarize the most important examination findings. The Matters Requiring Board Attention are intended to complement the complete Report of Examination's findings prepared for use by bank management and directors. This page or section is to focus on identified problems, rather than on strengths of the organization, and present them succinctly and unmistakably clearly. In all cases, the types of actions to be taken by the directors and management to address these problems should be specifically noted. See the section "Communication of Examination Findings" with regard to MRAs, MRAs, and Observations. Institutions rated 4 or 5 are to be told they are problem institutions that warrant special supervisory attention. Institutions rated 3 are to be informed that their condition is not satisfactory, that they are subject to more-than-normal supervision, and that they may become problems if their weaknesses are not addressed adequately.

The Matters Requiring Board Attention report page or section should label the comments therein as being either MRAs, MRAs, or Observations. As a general rule, examiners should expect fewer MRAs or MRAs in stronger organizations than in weaker ones. However, the presence of MRAs or MRAs does not preclude a strong or satisfactory rating. For example, while correction of any violation of law is essential, the presence of inadvertent violations that do not expose the organization to significant risk (such as insufficient Federal Reserve stock shortly after a capital injection or a technical



exception) would not preclude a strong rating if all other factors supported that rating. Conversely, the presence of a large number of examination findings that give rise to MRAs or MRAs that represent a threat to the safety and soundness of the organization or that signify an elevated consumer compliance risk exposure would generally preclude a satisfactory rating and may require consideration of an enforcement action. For institutions between these extremes, examiners should determine the impact of MRAs and MRAs on ratings and assess the need for an enforcement action by considering the severity of these weaknesses and their relative importance in light of all the factors influencing the assessment of the organization. The Federal Reserve examiner's use of this common terminology is designed to enhance the focus and efficiency of communicating supervisory expectations and overseeing their implementation. This page or section should also discuss significant weaknesses in 1- or 2-rated institutions.

In institutions where no specific matters are identified as requiring board attention, this page or section should provide a brief summary of the institution's condition. In all cases, this page or section should contain a concluding statement reminding the directorate of its responsibility to review the entire Report of Examination and should instruct each director to sign the Signature of Directors page.

## Examination Conclusions and Comments (Mandatory)

This report page or section should list the composite rating for the current examination and for the two previous examinations at the top of the page. In addition to the composite ratings, the numeric ratings of the six components will be disclosed for examinations began after January 1, 1997. This listing should be followed by the uniform definition of the assigned composite rating. The uniform definitions of the component ratings assigned need not be included in reports; however, they should be made available to bank management and directors upon request.

This report page or section should summarize examination findings, particularly those of significance. The examiner should also provide an overview of the bank's financial condition. The examiner's major recommendations and man-

agement's plans for corrective actions should also be covered on this page or section in appropriate detail, with references to additional supporting information elsewhere in the report. The examiner's comments should also elaborate on the matters requiring board attention listed. All comments should be presented in order of importance. The comments should be primarily on an exception basis, describing areas of the bank's operations and aspects of its financial condition that display weaknesses, deficiencies, or vulnerability. This does not preclude the examiner from recognizing positive actions taken by management; however, laudatory or conclusive remarks and endorsements of specific management actions should be avoided.

Significant recommendations presented elsewhere in the report should be mentioned on this page. Significant violations should also be discussed briefly on this page and in greater detail on the Violations of Laws and Regulations page or section; less serious violations should be noted and reference made to the violations page. Compliance with any enforcement actions should be briefly discussed on this page or section and state that details are provided on the Compliance with Enforcement Actions page.

The Examination Conclusions and Comments page or section and the Matters Requiring Board Attention page or section should not be duplicative and should be easily integrated if the issuance of a Director's Summary of Examination Findings proves necessary.

## Compliance with Enforcement Actions (Optional)

The Compliance with Enforcement Actions report page or section will be used if the bank is under any type of supervisory action or has ratified board resolutions at the request of the Federal Reserve or state banking authority. In all cases, the type and date of the action or resolutions and parties to the action should be listed. In addition, the examiner should generally list each provision requiring action and provide a comment addressing compliance with that provision. Specifically, the examiner should comment on how the bank accomplished compliance or the reason why the bank is not in compliance with a particular provision. These comments should be made at the examination when supervisory actions are initiated and at all subsequent examinations until the action is removed.

## Comparative Statements of Financial Condition (Mandatory)

The left column titled “Exam Date” should coincide with the FFIEC Consolidated Report of Condition and Income (the Call Report) for the period used—generally, the most recent quarter-end. If Call Report amendments have been made, the amended numbers should appear on this page. If a bank’s management has made any significant misclassifications that have caused examiners to amend any financial statements, the examiner’s numbers should appear on this page. The right column titled “Period Ended” should usually detail previous year-end information. However, the examiner may substitute a different date, such as a previous examination, when desired. All amounts listed in either column should conform to the Call Report instructions. This page should also reflect FASB 115 “Accounting for Certain Investments in Debt and Equity Securities” adjustments to capital. These adjustments are made according to the Call Report instructions and are reflected on the line item “common equity capital.”

## Capital Adequacy (Mandatory)

Capital is assessed at each full-scope examination. Consideration is specifically given to risk identified within the bank, equity maintenance, and any growth the bank might be experiencing.

The bank’s capital ratios should be presented as indicated on the report page or section. FASB 115 adjustments are not to be reflected in capital ratios. However, the effect of FASB 115 on stockholders’ equity, if material, should be discussed in the narrative. In cases when the condition of the bank has changed significantly since the last quarter-end (for example, an equity offering) and/or when examination findings have a material impact on conclusions regarding capital adequacy, the examiner should reflect these changes and findings in these ratios. When adjustments are made, the examiner should identify the date of the new capital calculation (presumably subsequent to quarter-end). In any event, when examination findings result in a change in a bank’s prompt-corrective-action designation, the ratios provided must be adjusted. The Capital Category line refers to the prompt-corrective-action (PCA) capital designa-

tion as described in the Federal Deposit Insurance Corporation Improvement Act. (See sections 4133.1 to 4133.3.) Report comments need to clearly convey that this designation is not the sole criterion for determining capital adequacy. If the bank is subject to restrictions under a PCA directive issued by the Board of Governors, a discussion of the directive’s requirements and the related capital-restoration plan are to be included.

The examiner should consider the volume of classified assets and any meaningful asset-quality trends. It is appropriate to address capital ratios adjusted for significant examination classifications in the narrative to emphasize the impact of examination classifications on any valuation reserves and the impact of deficiencies in valuation reserves on the bank’s capital adequacy.

The assessment of capital growth should include consideration of growth from various capital sources, including retained earnings and potential new capital-stock issues, and should be compared to growth in total assets, asset mix, market risk, concentration risk, risks associated with nontraditional activities, interest-rate risk, and off-balance-sheet risks. Risk-based capital guidelines factor in changes in balance-sheet composition and exposure to potential risk via growth of off-balance-sheet activities. Although the guidelines give consideration to the above, examiners still must exercise considerable judgment to evaluate all factors necessary to make an accurate assessment of capital adequacy.

The bank’s capital plan should also be reviewed. The content, degree of formality, sophistication, and form of plan will vary with banks of different sizes and complexity. However, each bank should be monitoring its capital position in relation to the required guideline ratios and risk. In addition, consideration should be given to the bank’s ability to obtain additional outside capital, including support provided by a parent holding company. Also, the bank’s dividend history and plans should be considered in relationship to regulatory guidelines and anticipated profitability.

## Capital Calculations (Mandatory)

The Capital Calculations page or section should be prepared using information as of the same date as the exam date shown on the Comparative

Statements of Financial Condition. When the condition of the bank has changed significantly since the exam date (for example, an equity offering) or when examination findings materially affect conclusions regarding capital adequacy, the examiner should reflect these changes and findings in the capital calculation. When adjustments are made, the examiner should identify the date of the new capital calculation. In any event, when examination findings result in a change in a bank's prompt-corrective-action designation, the capital calculations provided must be adjusted. Characteristics of any capital elements that are unusual or significant may require an explanation on the Capital Adequacy page or section, as may any limitations with regard to risk-based capital guidelines.

Ineligible intangibles to be deducted from tier 1 capital should include such items as ineligible purchased credit-card relationships (PCCRs) and mortgage-servicing rights, while the Other Adjustments line should include such items as disallowed deferred-tax assets. Under the risk-weighted assets calculations section, the examiner should ensure that requested data are calculated in accordance with risk-based capital guidelines. All items deducted from capital noted above should also be deducted from the risk-weighted assets calculation. FASB 115 adjustments are not to be reflected on this page or section. Adjusted average total assets is average total assets for the most recent quarter less all goodwill and other disallowed intangibles.

## Asset Quality (Mandatory)

Federal Reserve examiners should specifically address the following areas within the Asset Quality page or section. If all conditions are satisfactory, a brief statement that addresses each factor and summarizes the examiner's conclusions will suffice.

- Assess (1) the quality of assets, including their level, distribution, severity, and the trend of problem, classified, past-due, nonaccrual, restructured, and renegotiated loans not in compliance with modified terms for both on- and off-balance-sheet transactions; (2) the existence of asset concentrations; (3) the adequacy of loan policies and loan-administration, credit documentation, or lending practices;

(4) the adequacy of workout procedures for problem credits; (5) the adequacy of the allowance for loan and lease losses; and (6) the adequacy of the bank's internal loan-review and grading systems, including significant differences between internal loan grades and examination classifications.

- Assess (1) the quality of investment securities and (2) the adequacy of investment policies.
- Comment on any off-balance-sheet items, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit, with respect to (1) their volume in relation to total assets, capital, or other appropriate balance-sheet categories; (2) the risks inherent in the activity; and (3) the adequacy of management and control of off-balance-sheet risks.
- Comment on the quality of management with respect to the lending function and management's awareness of problem loans. Examiners should also address the causes of existing credit problems and remedial actions agreed to by management for correction of deficiencies.
- Assess the adequacy of internal controls and management information systems.

The Asset Quality report page or section should provide for a weighted-asset classification to capital ratio; the Federal Reserve System relies heavily on this measure of asset quality. The page or section should include a line for the ratio of weighted classifications to tier 1 capital and for the allowance for loan losses without limitation. The sample page included in this manual contains a line for this ratio.

Assets listed for special mention should neither be included in the classifications total nor should they be referred to as adversely classified in the narrative. Although classified and special-mentioned asset totals should not be commingled, those two categories will display and possibly share underwriting, documentation, or other weaknesses or characteristics to be reported by the examiner.

The examiner should consider the total of other transfer-risk problems, if significant, and briefly discuss the volume and trend of such credits. The examiner should specifically assess whether there are concentrations of credit in any particular economic sectors, the extent that problem credits may be centered in these sectors, and concentrations of transfer risk warranting special comment. Examiners should also address

the loan-loss reserve methodology and the adequacy of the allowance for loan and lease losses. Examiners should comment on the quality and valuation methods for investment securities and trading-account activities and address credit risk associated with off-balance-sheet items.

Examiners should assess the adequacy of policies and procedures relating to loans, investments, and off-balance-sheet activities. Also, examiners should address policies and procedures regarding financial futures, forwards, derivative transactions, and foreign-exchange trading and valuation.

When assessing loan policies, loan administration, and lending practices, consideration should be given to internal loan approval, internal review and monitoring, and grading systems and control procedures; the organization and completeness of the credit files; collateral administration and evaluation procedures; collection procedures; procedures for renewing or extending loans and placing loans on nonaccrual status; the accrual and capitalization of past-due interest and prepaid interest; and any other unfavorable practice that may result in or from poor asset quality.

Deficiencies relating to the lack of written policies in any critical area should be noted in discussing management's adherence to policies on the Management/Administration page or section. Also, if excessive management turnover, weaknesses in middle management, or inadequate internal promulgation of policies affects adherence to or implementation of policies, these areas should also be addressed under Management/Administration.

Examination ratios in this section are to be derived from information obtained during the current and two most recent on-site examinations. The examiner may include in the narrative additional ratios, if necessary, to highlight a particular financial factor. Reserve Banks that are engaged in alternate examination programs with state banking departments should use classified asset totals from state reports in completing and analyzing the trend in asset-quality data on this page.

For the Asset Quality page or section, the tier 1 capital numbers to be used should come from the Capital Adequacy and Capital Calculations pages. However, the examiner may substitute a different date when desired. The total adversely classified assets numbers and total assets numbers should be relevant to the date of the asset-quality review. This will reflect informa-

tion for the period deemed most appropriate by the examiner-in-charge.

Capital is based on the guideline definition of tier 1 capital. Weighted and total classifications are to be compared with tier 1 capital plus the allowance for loan losses, both for purposes of this page and for the asset-quality rating under the CAMELS rating system. Total adversely classified items includes total adversely classified assets plus classified off-balance-sheet items, while total adversely classified assets does not include classified off-balance-sheet items. The past-due and nonaccrual ratio should be consistent with the information contained in the past-due and nonaccrual schedule on the Loans and Lease-Financing Receivables/Past-Due and Nonaccrual Loans and Leases page or section.

### Summary of Items Subject to Adverse Classification/Summary of Items Listed as Special Mention (Mandatory)

#### *Summary of Items Subject to Adverse Classification*

The Summary of Items Subject to Adverse Classification page or section summarizes items classified by the examiner as of the examination date (for this page, considered the date relevant to the asset-quality review). Total classifications are also presented for the previous examination. Reserve Banks that are engaged in alternate examination programs should provide totals contained in the previous examination report prepared by the state when applicable. The examiner should also consider creating a schedule on the Asset Quality page or section to detail classifications from additional prior examinations if meaningful trend information is noted. The examiner should also present in the report narrative classifications trends for certain asset categories if the analysis is meaningful.

The report format does not contain provisions for other transfer-risk problems or value-impaired assets. For examination of banks engaged in international lending, Reserve Bank examiners should provide additional information to include categories for other transfer-risk problems and value-impaired assets. The format for this page or section will also require adjustments for U.S. addressees and non-U.S. addressees.

For banks with foreign activity, the distinction between U.S. and non-U.S. addressees follows the definition set forth in the instructions for the Call Report: whether a customer is U.S. or non-U.S. is determined by the customer's principal address, that is, by its domicile. A U.S. address would be in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. Non-U.S. addressees include all other geographic areas.

The examiner should list in the appropriate category the amounts of all credits classified due to transfer risk. The value of credits shown as value-impaired should be computed after deducting any allocated transfer-risk reserve established against an asset. In determining total classified assets, examiners should arrive at a net assets classified due to country risk. Examiners should identify any credits classified due to transfer risk that have received the same or more severe classification due to credit risk and are listed above in the summary of classified items due to credit risk. The sum of such assets should be listed in the appropriate column and then deducted to arrive at net assets classified due to country risk. For the purpose of this page or section, any credits classified as value-impaired for transfer-risk purposes should not be included in the summary of credits classified due to credit risk, unless the credits are classified loss.

For the purpose of arriving at total classified assets, add the amount classified due to credit risk to net assets classified due to transfer risk for each category. When computing weighted classifications, the residual portion of any value-impaired assets should be assigned the same weight as substandard classifications. However, the residual exposure still remains value-impaired for examination and classification purposes. Value-impaired assets held in the trading account should also be included in total classified assets but should not be considered classified assets when computing weighted classifications.

### *Summary of Items Listed as Special Mention*

The Summary of Items Listed as Special Mention page or section presents the total of assets listed for special mention. The summary includes special-mention totals for the current and one previous examination. Assets listed for special

mention are not included when computing classification ratios. Reserve Banks that are engaged in alternate examination programs should rely on the previous state examination's special-mention total when applicable.

### **Loans and Lease-Financing Receivables/ Past-Due and Nonaccrual Loans and Leases (Mandatory)**

The examiner has the flexibility to use the same or different dates for the Loans and Lease-Financing Receivables and the Past-Due and Nonaccrual Loans and Leases schedules. The Loans and Lease-Financing Receivables schedule will usually be as of the most recent quarter-end. The Past-Due and Nonaccrual Loans and Leases schedule will usually be as of the asset-quality review date. Based on examination findings, the examiner-in-charge should determine if other "as of" dates best reflect the condition of the institution. For example, the Loans and Lease-Financing Receivables schedule may be presented as of the asset-quality review date if the examiner identifies significant changes since the last quarter-end that need to be incorporated.

The format of the Loans and Lease-Financing Receivables schedule is similar to that used in the Call Report. The definitions of the loan categories as contained in the Instructions for the Call Report should be used in completing the schedule. For examinations of banks engaged in international lending, Reserve Bank examiners should adjust the format of this schedule for U.S. addressees and non-U.S. addressees.

For examinations of banks engaged in international lending, Reserve Bank examiners should adjust the format of the Past-Due and Nonaccrual Loans and Leases schedule for U.S. addressees and non-U.S. addressees. The definitions of past-due and nonaccrual loans and leases as contained in the Instructions for the Call Report should be used in completing this schedule, unless the bank's policy is more conservative, in which case the bank's definition may be used. If so, or if state law requires the bank to apply different definitions, the examiner should discuss the bank's policy or state law in the Comments section following the past-due and nonaccrual schedule. The Memorandum section should include the amount of restruc-



tured loans and leases included in the totals. Relevant issues pertaining to past-due and non-accrual loans and leases should be briefly discussed in the Comments section. More significant issues should be discussed on the Asset Quality page or section.

## Management/Administration (Mandatory)

The report-page heading states that management is evaluated against all factors necessary to operate the institution in a safe and sound manner and in accordance with acceptable practices. Consideration is given to technical competence, leadership, and administrative ability; compliance with regulations and statutes; ability to plan and respond to changing circumstances; effectiveness of management information systems; tendencies toward self-dealing; demonstrated willingness to serve the legitimate banking needs of the community; and management depth and succession. In addition, consideration is given to the extent that management is affected by or susceptible to dominant influence or concentration of authority.

In preparation for making report comments, examiners should consider the following:

- the adequacy of supervision by the board of directors, including its role in establishing policies and its responsiveness to recommendations from auditors and supervisory authorities
- compliance with supervisory agreements
- compliance with banking laws and regulations
- management's timeliness in recognizing and resolving problems
- the adequacy of the institution's policies necessary to operate the bank in a safe and sound manner and in compliance with applicable statutes and regulations (Examiners should review the mechanism for formulating, approving, reviewing, and updating policies; determine if the policies are in writing and are properly communicated to all appropriate personnel; and determine if all policies are followed.)
- management's adherence to policies as established by the board of directors
- management information systems and controls used to monitor and control risks throughout the bank and ensure compliance with established policies, statutes, and regulations (Examiners should also address the adequacy of the overall internal accounting-control system and the audit function employed by the bank. Deficiencies in internal accounting-control systems and the audit function should be discussed in detail.)
- the adequacy and effectiveness of the planning function, including planning and budgeting and the role of management in each process
- the business strategy and policies and procedures for avoiding conflicts of interest
- significant findings and conclusions noted in specialty examinations (for example, trust, EDP, CRA, and consumer) conducted since the previous full-scope commercial examination
- management depth and succession
- the extent that the board of directors and management are affected by or susceptible to dominant influence or concentration of authority
- demonstrated willingness to serve the legitimate banking needs of the community

While topics in this section may appear to overlap with other areas of the report, the discussion in this section should focus on the role of the bank's directors, the bank's internal administration, management supervision and policy development, and management's adherence to operating policies and procedures. This section should not repeat financial assessments set forth elsewhere in the report.

## Violations of Laws and Regulations (Mandatory)

The Violations of Laws and Regulations page or section should be included in every Federal Reserve examination; if there are no apparent violations, write "None." When violations of federal or state banking laws and regulations are found, they should be listed in detail on this page. Violations of the Bank Secrecy Act should also be listed on this page in detail.

The format for listing violations should be consistent. A heading for each violation listed should name the applicable regulation and section and provide a brief description of what the law covers. This should be followed by a brief description of the requirements of the regulation or statute and a discussion of how or why the

violation occurred. The examiner should describe any plans or recommendations for correction. If a review of the Bank Secrecy Act is conducted separately, or as part of another examination, a statement to this fact should be included on the Other Matters page or section.

## Earnings (Mandatory)

The exam-date column on the Earnings page or section should be prepared using information as of the same date as the exam date shown on the Comparative Statements of Financial Condition page or section. Ratios required on this page are available in the UBPR or may be calculated from the Call Report or the bank's records.

For this page or section, the examiner should address, at a minimum, the following:

- the level of earnings, including trends and stability
- the quality of earnings (for example, strength of the net interest margin, the amount of non-interest income and expense, reliance on unusual or nonrecurring gains or losses, and adequacy of provisions for loan losses)
- plans for correcting any earnings deficiencies
- the bank's budget and expense controls, such as management's earnings projections with regard to reasonableness of assumptions, actual results versus projections, and reasons for significant differences between projected and actual earnings
- the vulnerability of the bank's earnings to interest-rate and other risks (However, full discussion should be in the Liquidity/Asset Liability Management section of the report).
- the ability to provide for adequate capital through retained earnings

When assessing the quality of net income, the examiner should also consider the amount of interest accrued but not collected and other areas for possible overstatement of income. This amount may be reflected in other assets as income earned or not collected, or in the loan account as capitalized interest (interest added to the loan balance). The examiner should also consider the composition, reasonableness, and extent of management's control over operating expenses.

## Analysis of Earnings (Mandatory)

The exam-date columns on the Analysis of Earnings page or section should be prepared using information as of the same date as the exam date shown on the Comparative Statements of Financial Condition page or section. The different sections of this page are described below:

### *Comparative Statement of Income (Institution Only or Consolidated)*

Indicate whether this section is for the institution only or is consolidated. For the line item Other Increases/Decreases, reflect the period-to-period change in FASB 115 adjustments (gains/losses on available-for-sale securities).

### *Reconciliation of Allowance for Loan and Lease Losses*

Information for reconciliation of the allowance for loan and lease losses (ALLL) is available from bank records or call reports. The December 31 Consolidated Report of Income for all banks includes a reconciliation of this account on Schedule RI-B (Part II).

### *Other Component Ratios and Trends*

Ratios for this section can be obtained from information in the Call Report, the most recent UBPR, or bank records. The ratio Nonperforming/ALLL refers to noncurrent loans/ALLL as represented in the UBPR.

## Liquidity/Asset Liability Management (Mandatory)

The Liquidity/Asset Liability Management page or section addresses both overall bank liquidity and balance-sheet interest-rate sensitivity. Liquidity refers to the ability to meet maturing obligations and commitments and incorporates considerations such as availability of funding and the degree of reliance on volatile or concentrated funding sources. Interest sensitivity considers the overall matching of rate sensitivities of assets and liabilities and the responsiveness

of asset yields, interest expense, and interest margins to changes in market interest rates.

The examiner should consider the level and/or percentages of core and/or volatile deposits, including the composition and stability of deposits. In particular, the level of volatile deposits should be closely scrutinized, and the examiner should consider if the bank must pay premium rates to attract those funds. Volatile deposits are generally composed of certificates of deposit greater than \$100,000 and brokered deposits. Report comments should thoroughly discuss the bank's use of brokered deposits and evaluate the compliance of brokered deposit activity with regulatory guidelines. Report comments should also consider deposit and other liability concentrations and the extent of the bank's reliance on those concentrations. The examiner should also consider vulnerability of the institution's funding to adverse publicity and lowered credit ratings.

The report should consider the level and types of liquid assets. These assets include cash and balances due from depository institutions, U.S. government and agency securities, federal funds sold, and securities purchased under agreements to resell. Liquid assets should be maintained at a sufficient level to cover maturing obligations and allow extended commitments to be fulfilled. The level of temporary investments (federal funds sold, securities purchased under agreement to resell, interest-bearing bank balances, trading-account assets, and debt securities with remaining maturities or earliest pricing opportunities of one year or less) should also be considered. The examiner should also keep in mind the percentage of the bank's securities that are pledged against liabilities and be mindful of whether they are available for sale as well as of any market appreciation or depreciation in the investment portfolio.

To further analyze liquidity, a history of the bank's borrowings, such as federal funds purchased and repurchase agreements, and excess funds sold since the previous examination should be considered. Also, consideration should be given to the bank's ability to obtain borrowings from outside sources, should that be consistent with the bank's funding strategy.

The examiner needs to consider the bank's interest-rate risk exposure. The examiner should assess how the bank is monitoring exposure, any weaknesses inherent in the bank's system, and management's plans to correct any inappropriately mismatched positions. The volume and

impact of any derivative contracts should also be considered.

Examiners should assess the adequacy and reasonableness of the bank's policies regarding liquidity, interest-rate risk, and funding, as well as management's compliance with those policies. The examiner should also consider augmenting the discussion of the organization's liquidity and asset/liability management with gap information or other meaningful financial data presented in reporting schedules.

## Sensitivity to Market Risk (Mandatory)

This section reflects the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can affect a bank's earnings or economic capital. When evaluating, the examiner should consider management's ability to identify, measure, monitor, and control market risk; the bank's size and the nature and complexity of its activities; and the adequacy of the bank's capital and earnings in relation to its level of market-risk exposure.

For many banks, the primary source of market risk arises from nontrading position and their sensitivity to changes in interest rates. In some larger banks, foreign operations can be a significant source of market risk. For some banks, trading activities are a major source of market risk. To analyze a bank's market risk, an assessment of the following evaluation factors should be made:

- the sensitivity of the bank's earnings or the economic value of its capital to adverse changes in interest rates, foreign-exchange rates, commodity prices, or equity prices
- the ability of management to identify, measure, monitor, and control exposure to market risk, given the bank's size, complexity, and risk profile
- the nature and complexity of interest-rate risk exposure arising from nontrading positions
- where appropriate, the nature and complexity of market-risk exposure arising from trading and foreign operations

## Other Matters (Optional)

Examiners should use the Other Matters report



page or section to discuss other significant issues that have not been mentioned elsewhere in the report or significant matters mentioned elsewhere that require further explanation, such as the type, scope, and volume of any new activity in which the bank is engaged. Examiners should use this report page to make comments on the following specific areas if issues or concerns are noted:

- accounting, audit, and internal controls
- affiliate relationships
- criminal referral procedures
- emergency preparedness
- financial recordkeeping and reporting regulations
- insurance
- investment in bank premises
- litigation
- security and controls against external crimes
- payments system risk
- nontraditional banking activities (for example, mortgage warehousing or data processing services)
- supervisory reporting
- nondeposit investment products

Other examination matters may also warrant comments on this report page.

### Concentrations (Optional)

The Concentrations report page or section is to be used only when concentrations are noted. A brief paragraph at the beginning of the page or section should be included to inform the reader that the listing is generally for informational purposes and does not necessarily represent criticism unless otherwise specifically stated. This paragraph should also mention that a concentration includes obligations, direct or indirect, of the same or affiliated interests that represent 25 percent or more of the bank's capital structure. The reader should also be informed that, for the purposes of this page, the capital structure is defined as tier 1 capital plus the allowance for loan and lease losses.

When determining and calculating concentrations, the amount of loan commitments and other off-balance-sheet risk items should be considered. The listing should include all types of loans, overdrafts, cash items, suspense resources, securities, leases, acceptances,

advances, letters of credit, and all other items due to the bank, as well as loans endorsed, guaranteed, or cosigned by related individuals and their related interests.

Concentrations by industry, transfer risk, product line, type of collateral, and others are detailed where appropriate. The listing also includes amounts due from depository institutions, federal funds sold, and other assets where payment is dependent on one financial institution or affiliated group and the total represents 25 percent or more of the bank's capital structure. Treasury securities, obligations of U.S. government agencies and corporations, and any assets collateralized by these items are not included in the listing. The requirements of Regulation F should also be considered as they relate to concentrations involving correspondent banks. See sections 2015.1, 2015.2, 2015.3, and 2015.4.

### Items Subject to Adverse Classification (Optional)

The Items Subject to Adverse Classification page is to be included in the report if any items are subject to adverse classification. The page or section should include all assets that are classified but should not include assets listed for special mention. However, for examinations of banks that are involved in international lending, Reserve Banks should develop supporting pages to address exposures warranting special comment, other transfer-risk problems, and value-impaired credits. This page or section should be used by examiners for the individual write-ups for assets subject to classification, including any off-balance-sheet items. It should also be used to list assets subject to classification that do not require write-ups. Assets specially mentioned should be included on the page titled Items Listed for Special Mention.

Requirements for loan write-ups presented on this page are found in section 2060, "Classification of Credits." Examiners should rely on the definitions of substandard, doubtful, and loss, as defined in this section, when classifying assets.

### Items Listed for Special Mention (Optional)

The Items Listed for Special Mention page or

section is to be used if any items are listed for special mention. Any assets so listed should meet the definition of special mention found in the “Classification of Credits” section of this manual. Specially mentioned assets must be written up if they exceed the loan review cutoff amount and if the bank’s management disagrees with the examiner’s findings with regard to the asset. Specially mentioned assets are not to be referred to as “criticized assets.” Write-up guidelines for specially mentioned assets are the same as those for classified assets enumerated in the “Classification of Credits” section of this manual.

### Assets with Credit-Data or Collateral-Documentation Exceptions (Optional)

The Assets with Credit-Data or Collateral-Documentation Exceptions page or section should be included in the report if a significant volume of documentation exceptions is noted. If credit-data or collateral-documentation exceptions are significant, this page or section should support a discussion of credit-documentation practices on the Asset Quality page or section. In addition to the six common documentation exceptions listed, the illustrated page heading includes space to list other exceptions noted at a particular examination.

Examiners should refrain from listing in this section any loans that bank management has elected to identify as exempt from certain documentation requirements under the March 10, 1993, Interagency Policy Statement on Documentation of Loans to Small and Medium-Sized Businesses and Farms or any other applicable guidelines. See SR-93-30 and its attachments and FRRS at 3-1511. The policy statement is intended to eliminate unnecessary documentation on small and medium-sized business and farm loans for institutions that are highly rated and that are well or adequately capitalized. Under the provisions of the policy statement, these institutions are allowed to identify, within certain limits, an “exempt portion” of their small and medium-sized business and farm-loan portfolios that examiners are to evaluate solely on performance and are exempt from examiner criticism of documentation. With regard to the applicability of the policy statement to the activities of U.S. branches and agencies of foreign banks, see SR-93-26.

### Signature of Directors (Mandatory)

The Signature of Directors report page is to be signed by the directors of the bank upon receipt of the completed report and retained in the bank’s records for review by examiners during subsequent examinations.

### Confidential Section—Directors (Mandatory)

The Confidential Section—Directors should list all bank directors in alphabetical order. If the bank elects advisory directors, they should be listed alphabetically under a separate heading.

Information requested in the illustrated report-page or section header should be supplied for each director. Specific instructions for certain requested information is as follows:

- Under meetings missed, include all meetings a director has not attended between the previous (FRB or state) and current examination. If a director was elected since the previous examination, only list the number of meetings that he or she missed since the date of election.
- Under fees paid to each director, indicate whether the compensation is based on attendance.
- Under occupation or principal business affiliation, use concise and descriptive designations (for example, farmer, grocer, commercial real estate development).

For banks with active board committees, a code or legend for all committees should be prepared, indicating committee memberships for each director.

### Confidential Section—Executive Officers (Mandatory)

The Confidential Section—Executive Officers page or section employs the Regulation O definition of executive officers, but other significant officers may be included at the discretion of the examiner. Information requested by the report page should be supplied.

Additional individuals to be reported may include persons without official designation that exercise considerable influence or executive of-

Officers excluded from the Regulation O definition by board resolution who actually maintain a high level of responsibility. Officers should be listed in order of title or position of responsibility, with dominant individuals shown first. Specific instructions for this requested information is as follows:

- Examples of areas of responsibility include administration, policy formulation, lending, operations, or branch manager.
- Salary should indicate the current annual salary, and bonus should show total bonuses for the previous year.

If executive officers receive any other pertinent forms of compensation beyond their listed salary and bonus (such as commission-based pay, employment contracts, stock options, unusually large benefits and insurance policies or other personal benefit programs, or affiliated bank salaries and fees), these should be discussed in a narrative format below the listing of executive officers or on a separate page.

### Confidential Section—Management and Control (Mandatory)

The examiner should respond to each listed question included or illustrated on the Confidential Section—found on the Management and Control page or section. The following instructions are keyed to respective question numbers:

1—Generally, the examiner’s assessment of management should be fully discussed in the open section of the report; however, this question provides a forum to discuss any supervisory matter regarding management that clearly requires confidential treatment.

2—Each principal shareholder’s ability and willingness to offer support to a weakened bank should be assessed. Any other potential forms of support, such as a parent company, other affiliate, or third party desiring to acquire this bank should also be identified. The possibility or likelihood of forthcoming support should also be addressed.

3(a)—Each major shareholder of the bank should be listed, with footnotes for any indirect control, such as control over spousal or family trust

shares. Finally, any special control arrangements, such as buy-sell agreements or control-group structures, should be noted.

3(b)—The degree of control or influence exercised by any one individual or group of individuals should be discussed and include an indication of whether this influence has been positive or detrimental to the bank.

3(c)—In addition to any abusive practices that should be discussed here, such as self-dealing, any other problems, such as weak or unsatisfactory management or other relevant factors, should be addressed.

3(d)—The volume of insider borrowings and the impact of those transactions on the bank should be commented on. If the bank is using the Regulation O small-bank exception regarding aggregate insider borrowings (see section 215.4(d)(2) of Regulation O (12 CFR 225.4(d)(2)—member banks with deposits of less than \$100,000,000), it should be noted, including the presence of the required board resolution sanctioning that level.

4—Any filing of a Suspicious Activity Report (SAR-DI) form or any bond claim relating to insiders should be commented on. The examiner is to explain why legal authorities have not been informed of possible criminal activity.

### Confidential Section—Ratings and General Information (Mandatory)

The examiner should respond to each question included or illustrated in the Confidential Section—Ratings and General Information page or section. The following instructions are keyed to the respective question numbers:

2—Items for possible discussion include the bank’s trade area, major employers or primary industries, the area’s economic condition and trend, and the bank’s ability to operate satisfactorily within this environment. Other discussion topics could include competition, expansion plans, and strategic direction.

5—Individuals with Central Point of Contact (CPC) or EIC responsibilities should be listed,

with primary work areas shown for all other examiners (that is, loans or operations). For joint examinations, the agency for non-FRB examiners should be listed. If an examiner was in training and required significant assistance, that person should be designated as a trainee.

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 COMMERCIAL BANK REPORT OF EXAMINATION
 

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NAME OF BANK	STREET	CITY
COUNTY	STATE	ZIP CODE
_____ JOINT	_____ CONCURRENT	_____ INDEPENDENT

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SIGNATURE OF DIRECTORS .....	*

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Dollar amounts are in thousands unless otherwise indicated.

\*Mandatory

\*\*Optional pages, per interagency guidelines, become mandatory if the material is appropriate.

EXAMINATION CONCLUSIONS AND COMMENTS

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Uniform Financial Institutions Rating System

Exam date: *Current Exam*      *Prior Exam*      *Prior Exam*  
Composite rating:

- Component ratings:
- Capital
  - Asset Quality
  - Management
  - Earnings
  - Liquidity
  - Sensitivity to Market Risk

Examiner-in-Charge \_\_\_\_\_

Additional Sign-Off \_\_\_\_\_

## COMPARATIVE STATEMENTS OF FINANCIAL CONDITION

(Institution only or consolidated)

(Amounts reported in thousands)

	<i>Exam Date</i>	<i>Period Ended</i>
<b>ASSETS</b>		
Total loans and leases		
Less: allowance for loan and lease losses		
Loans and leases (net)		
Interest-bearing balances		
Federal funds sold		
Securities purchased under agreements to resell		
Trading-account assets		
Securities		
Total earning assets		
Cash and non-interest-bearing balances		
Premises and fixed assets		
Other real estate owned		
Intangibles		
Other assets		
Total assets		
<b>LIABILITIES</b>		
Deposits		
Federal funds purchased		
Securities sold under agreements to repurchase		
Other borrowed money		
Other liabilities		
Subordinated notes and debentures		
Total liabilities		
<b>EQUITY CAPITAL</b>		
Perpetual preferred stock		
Common equity capital		
Other equity capital		
Total equity capital		
Total liabilities and capital		
<b>OFF-BALANCE-SHEET ITEMS</b>		
Unused loan commitments		
Letters of credit		
Interest-rate contracts		
Other off-balance-sheet items		

## CAPITAL ADEQUACY

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Capital adequacy is evaluated in relation to supervisory guidelines, the nature and extent of risks to the organization, and the ability of management to address these risks. Consideration is given to the level and quality of capital and the overall financial condition of the bank; the nature, trend, and volume of problem assets and the adequacy of the allowance for loan and lease losses and other valuation reserves; risk exposures presented by off-balance-sheet activities; the quality and strength of earnings; balance-sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and nontraditional activity risk; growth experiences, plans, and prospects; the reasonableness of dividends; access to capital markets and other appropriate sources of financial assistance; and the ability of management to address emerging needs for additional capital.

Component Rating      X

---

### CAPITAL RATIOS AND TRENDS

<i>Ratio</i>	<i>Exam Date</i>	<i>Period Ended</i>	<i>Period Ended</i>
Total risk-based capital/ risk-weighted assets	%	%	%
Tier 1 risk-based capital/ risk-weighted assets	%	%	%
Tier 1 leverage capital/ average total assets	%	%	%
Tangible equity capital/ average total assets	%	%	%
Capital category			



## CAPITAL CALCULATIONS

	<i>\$(000's)</i>	<i>Date</i>
Tier 1 Capital		
Common stock		
Surplus		
Undivided profits and capital reserves		
Foreign-currency-translation adjustments		
Noncumulative perpetual preferred stock and surplus		
Minority interests		
Subtotal: tier 1 capital elements		
Less:		
Ineligible intangibles		
Other adjustments		
Tier 1 capital		
Tier 2 Capital		
Allowance for loan and lease losses*		
Mandatory convertible debt		
Agricultural loss deferral		
Cumulative perpetual preferred stock		
Subordinated debt		
Other		
Tier 2 capital (not to exceed 100% of tier 1 capital)		
Total Capital		
Tier 1 plus tier 2 capital		
Less: deductions		
Total capital		
Risk-Weighted Assets Calculation		
Risk-weighted balance-sheet assets		
Risk-weighted off-balance-sheet items		
Less: risk-weighted amounts deducted from capital		
Gross risk-weighted assets		
Less: excess ALLL and ATRR		
Total risk-weighted assets		
Adjusted total assets		
Less: amounts deducted from tier 1 capital		
Adjusted average total assets		

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\* Limited to a maximum of 1.25 percent of gross risk-weighted assets.

## ASSET QUALITY

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Asset quality is evaluated in relation to the level, distribution, severity, and trend of problem, classified, delinquent, nonaccrual, nonperforming, and restructured assets, both on- and off-balance-sheet; the adequacy of the allowance for loan and lease losses and other valuation reserves; the demonstrated ability to identify, administer, and collect problem assets; the diversification and quality of loan and investment portfolios; the adequacy of loan and investment policies, procedures, and practices; the extent of securities underwriting activities and exposure to counterparties in trading activities; credit risk arising from or reduced by off-balance-sheet transactions; asset concentrations; the volume and nature of documentation exceptions; and the effectiveness of credit-administration procedures, underwriting standards, risk-identification practices, controls, and management information systems.

Component Rating      X

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### ASSET-QUALITY RATIOS AND TRENDS

<i>Ratio</i>	<i>Exam Date</i>	<i>Prior Exam</i>	<i>Prior Exam</i>
Total adversely classified items/ tier 1 capital + allowance	%	%	%
Total adversely classified assets/ total assets	%	%	%
Past-due and nonaccrual loans and leases/ gross loans and leases	%	%	%
Weighted adversely classified items/ tier 1 capital + allowance	%	%	%

SUMMARY OF ITEMS SUBJECT TO ADVERSE CLASSIFICATION/  
SUMMARY OF ITEMS LISTED AS SPECIAL MENTION

<i>Asset Category</i>	<i>Adversely Classified</i>			
	<i>Substandard</i>	<i>Doubtful</i>	<i>Loss</i>	<i>Total</i>
Loans/leases				
Securities				
Other real estate owned				
Other assets				
Totals at this exam (MM/DD/YY)				
Totals at prior exam (MM/DD/YY)				

SUMMARY OF ITEMS LISTED AS SPECIAL MENTION

	<i>Exam Date</i>	<i>Prior Exam</i>
Loans/leases		

LOANS AND LEASE-FINANCING RECEIVABLES

---

*Date* \_\_\_\_\_

<i>Category</i>	<i>Amount</i>	<i>Percent</i>
Real estate loans		
Installment loans		
Credit card and related plans		
Commercial loans		
All other loans and leases		
Gross loans and leases	=====	=====

PAST-DUE AND NONACCRUAL LOANS AND LEASES

---

*Date* \_\_\_\_\_

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<i>Category</i>	<i>Past Due 30 through 89 Days</i>	<i>Past Due 90 Days or More</i>	<i>Total Past-Due and Accruing</i>	<i>Percent</i>	<i>Non- accrual</i>	<i>Percent</i>
Real estate loans						
Installment loans						
Credit card and related plans						
Commercial and all other loans						
Totals	=====	=====	=====	=====	=====	=====
<b>MEMORANDUM</b>						
“Restructured” loans and leases included in the above totals:	=====	=====	=====	=====	=====	=====

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COMMENTS

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## MANAGEMENT/ADMINISTRATION

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Management and the board of directors are evaluated against all factors necessary to operate the institution in a safe and sound manner and their ability to identify, measure, monitor, and control the risks of the institution's activities. Consideration is given to the level and quality of oversight and support provided by management and the board; compliance with regulations and statutes; the ability to plan for and respond to risks that may arise from changing business conditions or initiation of new products or services; the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems; the adequacy of and compliance with internal policies and controls; the adequacy of audit and internal control systems; the responsiveness to recommendations from auditors and supervisory authorities; the reasonableness of compensation policies and avoidance of self-dealing; a demonstrated understanding and willingness to serve the legitimate banking needs of the community; management depth and succession; the extent that management is affected by or susceptible to dominant influence or concentration of authority; and the overall performance of the institution and its risk profile.

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Component Rating	X
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## EARNINGS

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Quality and quantity of earnings are evaluated in relation to the ability to provide for adequate capital through retained earnings; level, trend, and stability of earnings; quality and sources of earnings; level of expenses in relation to operations; vulnerability of earnings to market-risk exposures; adequacy of provisions to the allowance for loan and lease losses and other valuation reserves; reliance on unusual or nonrecurring gains or losses; contribution of extraordinary items, securities transactions, and tax effects to net income; and adequacy of budgeting systems, forecasting processes, and management information systems.

Component Rating      X

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### COMPONENT RATIOS AND TRENDS

<i>Ratio</i>	<i>Exam Date</i>	<i>Period Ended</i>	<i>Period Ended</i>
Net income (after tax)/average assets	%	%	%
Net operating income (after tax)/ average assets	%	%	%

## ANALYSIS OF EARNINGS

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 Comparative Statement of Income (Institution Only or Consolidated)

	<i>Exam Date</i>	<i>Period Ended</i>
Interest income		
Interest expense		
Net interest income		
Non-interest income		
Total non-interest expense		
Provision for loan & lease losses		
Provision for allocated transfer risk		
Securities gains (losses)		
Net operating income (pre-tax)		
Applicable income taxes		
Net operating income (after-tax)		
Extraordinary credits (charges), net		
Net income		
Other increases/decreases		
Cash dividends		
Net change in equity accounts		

## Reconciliation of Allowance for Loan and Lease Losses

	<i>Exam Date</i>	<i>Period Ended</i>
Beginning balance		
Gross loan and lease losses		
Recoveries		
Provision for loan and lease losses		
Other increases (decreases)		
Ending balance		

## Other Component Ratios and Trends

<i>Ratio</i>	<i>Exam Date</i>	<i>Period Ended</i>	<i>Period Ended</i>
Net interest income (TE)/average earning assets			
Total non-interest expense/average assets			
Net income/average total equity			
Net losses/average total loans and leases			
Earnings coverage of net losses (X)			
ALLL/total loans and leases			
Nonperforming/ALLL			

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## LIQUIDITY/ASSET LIABILITY MANAGEMENT

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Liquidity and asset/liability management is evaluated in relation to the trend and stability of deposits; degree and reliance on short-term, volatile sources of funds, including any undue reliance on borrowings or brokered deposits to fund longer-term assets; availability of assets readily convertible to cash without undue loss; availability to securitize and sell certain pools of assets; access to money markets and other sources of funding; adequacy of liquidity sources and ability to meet liquidity needs; effectiveness of liquidity policies and practices, funds-management strategies, management information systems, and contingency-funding plans; capability of management to properly identify, measure, monitor, and control liquidity; and level of diversification of funding sources, both on- and off-balance-sheet.

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Component Rating	X
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## SENSITIVITY TO MARKET RISK

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Sensitivity to market risk reflects the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect earnings or the economic value of capital; the ability of management to identify, measure, monitor, and control exposures to market risk given the bank's size, complexity, and risk profile; the nature and complexity of interest-rate risk arising from nontrading positions; and, where appropriate, the nature and complexity of interest-rate risk arising from trading and foreign operations.

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Component Rating	X
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## ITEMS SUBJECT TO ADVERSE CLASSIFICATION

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Includes assets and off-balance-sheet items which are detailed in the following categories:

*Substandard Assets*—A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

*Doubtful Assets*—An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

*Loss Assets*—An asset classified loss is considered uncollectible and of such little value that continuance as a bankable asset is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified loss should be promptly charged off.

<i>Amounts, Description, and Comments</i>	<i>Classification Category</i>		
	<i>Substandard</i>	<i>Doubtful</i>	<i>Loss</i>

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**ITEMS LISTED FOR SPECIAL MENTION**

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Includes assets that are detailed as follows:

*Special-Mention Assets*—A special-mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special-mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

*Description*

*Amount*

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**ASSETS WITH CREDIT-DATA OR COLLATERAL-DOCUMENTATION EXCEPTIONS**


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Includes assets with technical defects not corrected during the examination for which deficiency the appropriate number or description is noted in the Deficiency column.

1—Appraisal	5—Insurance
2—Title Search or Legal Opinion	6—Collateral Assignment
3—Borrowing Authorization	7—
4—Recordation	8—

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<i>Name or Description</i>	<i>Amount</i>	<i>Date of Most Recent Financial Statement</i>	<i>Deficiency Number(s) or Description</i>
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CONFIDENTIAL SECTION  
DIRECTORS

<i>Name</i>	*	<i>Year of Birth</i>	<i>Year Elected to Board</i>	<i>Occupation or Principal Business Affiliation</i>

\* Number of meetings missed of a total of \_\_\_\_\_ held since the previous examination.

Regular schedule of directors' meetings:

Fee paid each director:

CONFIDENTIAL SECTION  
EXECUTIVE OFFICERS

<i>Name and Title</i>	<i>Area of Respon- sibility</i>	<i>Year of Birth</i>	<i>Years with Bank</i>	<i>Years in Present Position</i>	<i>Compen- sation (Bonus)</i>
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CONFIDENTIAL SECTION  
MANAGEMENT AND CONTROL

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1. DISCUSS ANY OTHER RELEVANT MATTERS REGARDING THE BANK'S MANAGEMENT NOT PREVIOUSLY ADDRESSED.
2. IF THE BANK IS IN A WEAKENED OR EXTENDED CONDITION, WHAT AID MAY BE EXPECTED FROM SHAREHOLDERS OR OTHERS?
3. (A) LIST EACH MAJOR SHAREHOLDER (5 PERCENT OR MORE) OF THE BANK AND THE RESPECTIVE PERCENTAGE OF OWNERSHIP. WHEN THE MAJOR SHAREHOLDER IS A BANK HOLDING COMPANY, LIST ITS MAJOR SHAREHOLDERS AND THE PERCENT CONTROLLED.

*Shareholders*

*Percentage Owned*

- (B) COMMENT ON THE EXTENT TO WHICH A PARTICULAR DIRECTOR(S), SHAREHOLDER(S), OR EXECUTIVE OFFICER(S) CONTROLS OR DOMINATES THE BANK'S POLICIES AND OPERATIONS.
- (C) COMMENT ON ANY ADVERSE EFFECTS OF INSIDERS ON OPERATING POLICIES, PROCEDURES, OR OVERALL FINANCIAL CONDITION OF THE BANK.
- (D) PROVIDE THE AGGREGATE AMOUNT OF BORROWINGS BY DIRECTORS, EXECUTIVE OFFICERS, PRINCIPAL SHAREHOLDERS, AND THEIR RELATED INTERESTS (AS DEFINED IN REGULATION O). DESCRIBE ANY MATERIAL LOANS OR OTHER TRANSACTIONS BETWEEN THE BANK AND ITS EXECUTIVE OFFICERS, DIRECTORS, OR ITS DIRECT OR INDIRECT PRINCIPAL SHAREHOLDER(S) AND THEIR INTEREST(S), AND ASSESS THE IMPACT OF THE TRANSACTIONS ON THE BANK. (AN INTEREST WOULD INCLUDE ANY HOLDING COMPANY AFFILIATE OR OUTSIDE BUSINESS INTEREST OR A BANK OR HOLDING COMPANY INSIDER IN WHICH 25 PERCENT OR MORE IS CONTROLLED.)
4. HAS ANY DIRECTOR, OFFICER, OR EMPLOYEE ALLEGEDLY EMBEZZLED, ABSTRACTED, OR OTHERWISE CRIMINALLY MISUSED THE FUNDS OF THE BANK SINCE THE PREVIOUS EXAMINATION? IF SO, HAVE PROPER AUTHORITIES BEEN NOTIFIED? IF PROPER AUTHORITIES HAVE NOT BEEN NOTIFIED, EXPLAIN WHY.



CONFIDENTIAL SECTION  
RATING AND GENERAL INFORMATION

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1. STATE THE BANK'S RATING AT THIS EXAMINATION AND THE DATE OF AND RATING AT THE LAST EXAMINATION. BRIEFLY DISCUSS THE RATIONALE FOR THE RATING AND REASONS FOR ANY DEPARTURES FROM FEDERAL RESERVE IMPLEMENTING GUIDELINES WITH RESPECT TO THE CAMELS COMPONENT RATINGS AND THE COMPOSITE RATING.
2. DISCUSS PROSPECTS OF THE BANK.
3. WAS A MEETING HELD WITH THE FULL BOARD OF DIRECTORS TO DISCUSS MATTERS SUBJECT TO CRITICISM? IF NOT, GIVE NAMES OF DIRECTORS AND OFFICERS WITH WHOM THE BANK'S CONDITION WAS DISCUSSED.
4. PROVIDE THE COMPOSITE RATINGS AND DATES OF THE MOST RECENT BANK SPECIALTY EXAMINATIONS (EDP, TRUST, CONSUMER, CRA) AND BANK HOLDING COMPANY INSPECTION, IF APPLICABLE. IF ANY SPECIALTY EXAMINATION OR INSPECTION RESULTED IN A PROBLEM RATING, DISCUSS ANY ADVERSE IMPACT OF THOSE PARTICULAR WEAKNESSES ON THE OVERALL SAFETY AND SOUNDNESS OF THE BANK.

Bank Specialty Examinations	Date	Rating
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5. INDICATE THE NUMBER OF FEDERAL RESERVE EXAMINER DAYS TO COMPLETE THE PRE-EXAMINATION, ON-SITE, AND POST-EXAMINATION WORK.

Name	On Premises	Off Premises
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Examiner

Developments in technology, the expansion of financial services, and a risk-focused approach to examinations necessitate an increased flexibility in structuring and organizing the content of community bank examination reports. The reporting format for community bank examinations has been revised to focus more on “content.” The format allows examiners to use certain content headings, which follow a continuous-flow reporting format, and to use certain required report pages. The community bank examination report format may, however, continue to consist of specific or individual report “pages.”

The community bank reporting instructions distinguish between *mandatory* content (when the bank’s condition or circumstances warrant) versus *optional* content. The examiner thus has discretion in the arrangement of certain content. This guidance applies *only* to the preparation of community bank examination reports. See SR-01-19.

Subject to certain limitations, the examiner may customize and streamline the community bank examination report to better focus the examination’s findings on matters of risk and importance to the bank’s overall financial con-

dition. The revised format for the community bank examination report and its instructions should strengthen communications with the bank’s board of directors and senior management and minimize reporting burden. The report incorporates the specialty examination’s findings with the overall safety-and-soundness findings, thus culminating in a more comprehensive safety-and-soundness assessment.

The scope and depth of matters discussed under a content heading or on an examination report page, whether required or optional, will vary based on the issues and areas of concern presented, as well as on their severity. A more abbreviated discussion may be warranted for community banks that are found to be in sound financial condition, with no material concerns or issues. All examination reports should contain sufficient documentation to support any significant findings, issues, supervisory conclusions, and examiner recommendations.

The following table lists, in their required order, the content headings or report pages of the open and confidential sections of the community bank examination report.

### Community Bank Examination Report Content

<i>Mandatory/ optional</i>	<i>Required report page or section heading</i>
	OPEN SECTION
Mandatory	Cover Page ( <i>Separate page required.</i> )
Mandatory	Table of Contents ( <i>Separate page required.</i> )
Mandatory	Scope ( <i>Combined or separate page.</i> )
Mandatory	Matters Requiring Board Attention and Examination Conclusions and Comments ( <i>Combined with the Scope or a separate page.</i> )
Optional*	Compliance with Enforcement Actions
<i>The order of the following is at the examiner’s discretion.</i>	
Mandatory	Management/Administration and Risk Management ( <i>Separate section required.</i> )
Optional	Risk Assessment Matrix
Mandatory	Analysis of Financial Factors ( <i>Separate section required.</i> )
	Capital Adequacy
	Asset Quality
	Earnings
	Liquidity
	Sensitivity to Market Risk

*Other optional and mandatory pages or sections:*

Optional*	Information Technology Assessment
Optional*	Fiduciary Activities Assessment
Mandatory	Summary of Items Subject to Adverse Classification/Summary of Items Listed as Special Mention
Optional	Loans and Lease-Financing Receivables/Past-Due and Nonaccrual Loans and Leases
Optional*	Items Subject to Adverse Classification
Optional*	Items Listed for Special Mention
Optional*	Assets with Credit-Data or Collateral-Documentation Exceptions
Optional*	Concentrations
Optional*	Violations of Laws and Regulations
Optional	Other Matters
Mandatory	Comparative Statement of Financial Condition
Mandatory	Comparative Statement of Income
Optional*	Capital Calculations

The capital calculations are optional. *However, they may be mandatory if* (1) the bank has a financial subsidiary within the meaning of the Gramm-Leach-Bliley Act, (2) there is a change in the capital category as a result of the examination, or (3) the ratios supporting the capital category in the examination are not derived from the bank's Call Report as of the same date. Exception 3 could occur if the examination ratios were calculated at a date other than a quarter-end or, if calculated at quarter-end, the numbers were adjusted or changed from those filed in the Call Report.

Optional	Other Financial Pages <i>(At the examiner's discretion, other financial pages may alternatively be included in an appendix to the report or in the confidential section.)</i>
Mandatory	Signature of Directors <i>(A separate page is required. The signature page should be the last page in the report.)</i>

## CONFIDENTIAL SECTION

*The order of the following is at the examiner's discretion.*

Mandatory	Directors and Officers
Mandatory	General Information

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\* Indicates optional pages that are mandatory if circumstances relevant to the page apply.

## COMMUNITY BANK EXAMINATION REPORT INSTRUCTIONS

### Open Section

#### *Content Heading or Report Page Title*

*Cover page.* A separate cover page is mandatory.

*Table of contents.* A separate table of contents page is mandatory. The table of contents indicates the pages included in the report. All mandatory pages are to be included in each examination report. Optional pages are added as necessary. The mandatory Signature of Directors page is the last page in the open section of the report. Additional supplemental pages may be added to the report at the examiner's discretion.

Page numbers should be included for completeness. The page-numbering system may vary among Reserve Banks.

#### *Scope*

The Scope content heading or report page is mandatory. It may be a *combined* content heading or a *separate* report page. The scope should include the examiner's comments on examination depth, scope, and procedures performed for each area of review, including any specialty areas. The examination's scope should generally address the following:

- the date of examination (commencement and conclusion)
- the type of examination (full-scope, targeted, joint, concurrent, combined (bank and bank holding company))
- the agency or agencies conducting the community bank examination
- areas reviewed and analyzed (If the examination is targeted, the examiner should identify specific areas reviewed.)
- the percentage and type of loans reviewed, if any
- a confirmation that examination results were discussed with the organization, including a list of those who attended the meeting
- identification of the bank's peer group
- if necessary, recognition that the bank is operating under a formal or informal supervi-

sory action (If so, state that the provisions of the action were reviewed and compliance was assessed.)

#### *Matters Requiring Board Attention, and Examination Conclusions and Comments*

The content heading or report page is mandatory. The content of the heading or page may be combined with the Scope content heading, or it may be in the form of a separate report page. This section of the examination report informs the bank's board of directors of the most significant and most important supervisory issues or concerns identified during the examination as well as the examination's general conclusions—a summary of the most important findings. The Matters Requiring Board Attention content heading or report page is intended to complement the complete findings of the Report of Examination and is prepared for the use of the board of directors and the bank's management. The focus should be on identified problems, rather than on strengths of the organization. Problems should be presented succinctly and unmistakably clearly. In all cases, the types of actions to be taken by the directors and management to address these problems should be specifically noted.

All supervisory ratings assigned during the examination and for the two previous examinations should be provided. The board of directors and senior management of an institution that is rated a composite 4 or 5 are to be informed that the bank is a problem institution that warrants special supervisory attention. The board of directors and senior management of banks that are rated composite 3 are to be informed that their condition is not satisfactory, that the bank may be subject to more-than-normal supervision, and that the cited supervisory issues and areas of concerns may cause their bank to be considered a problem institution if the weaknesses are not promptly and adequately addressed. This content heading or report page should also discuss significant weaknesses in 1- or 2-rated institutions, and a brief summary of the bank's condition should be provided. Include any specialty or targeted examination ratings assigned or other assessments, including findings from other on-site visits during the recent Federal Reserve examination cycle. In all cases, a concluding statement should be provided that reminds the directorate of its responsibility to review the entire Report of Examination. The

report should instruct each director to sign the Signature of Directors page.

The supervisory ratings should be followed by the uniform definition of the assigned composite rating. The uniform definitions of the component ratings assigned need not be included in reports; they should, however, be made available to the board of directors and management on request. This content heading or report page should summarize examination findings, particularly those of significance. The examiner should also provide an overview of the bank's financial condition. The examiner's major recommendations and management's plans for corrective actions should also be covered in appropriate detail, with references to additional supporting information elsewhere in the report. All comments should be presented in order of importance. Comments should be provided primarily on an exception basis; that is, they should describe areas of the bank's operations and aspects of its financial condition that display weaknesses, deficiencies, or vulnerability. However, the examiner is not precluded from recognizing positive actions taken by management. Laudatory or conclusive remarks and endorsements of specific management actions, however, should be avoided.

Significant recommendations presented elsewhere in the report should be mentioned. Significant violations should also be discussed briefly, but they should be presented in greater detail under the content heading or the report page for Violations of Laws and Regulations.

### *Compliance with Enforcement Actions*

The content heading or report page is optional.

*The order of the following headings or pages is at the examiner's discretion.*

### *Management/Administration and Risk Management*

The content heading or report page is mandatory. A separate section is required. The reported information under this content heading should always include (1) the risk-management numerical rating; (2) the mandatory discussion of the risk factors—types of risk (that is, credit risk,

market risk, liquidity risk, operational risk, legal risk, and reputational risk); (3) the adequacy of risk management associated with risk levels and risk trends; and (4) the impact of specialty examination areas on relevant risk areas. The fourth item, for example, might consist of a discussion of the impact of any information technology concerns on operational and other relevant risks, what impact any findings on fiduciary activities have on legal or other risks, or compliance concerns.

Within this section of the report, management and the board of directors are to be evaluated against all factors necessary to operate the institution in a safe and sound manner and on their ability to identify, measure, monitor, and control the risks of the institution's activities. Consideration is given to (1) the level, quality, and adequacy of supervisory oversight and support provided by the board of directors and senior management; (2) compliance with banking and other statutes, regulations, and supervisory agreements; (3) the ability to plan for and respond to risks that may arise from changing business conditions or the initiation of a new product or service; (4) the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems used to control risks throughout the bank; (5) the adequacy and level of compliance with the board of directors policies and procedures and the bank's other internal policies and controls that are necessary to operate the bank in a safe and sound manner; (6) the adequacy of internal accounting control systems, the bank's audits and audit function, and the bank's internal control systems (discuss all of these in detail); (7) the responsiveness to recommendations from auditors and supervisory authorities; (8) the reasonableness of compensation policies and avoidance of, or tendency toward, self-dealing; (9) the business strategy and policies and procedures for avoiding conflicts of interests; (10) a demonstrated understanding and willingness to serve the legitimate banking needs of the community; (11) the institution's management depth and succession; (12) the extent that management is affected by or is susceptible to dominant influence or concentration of authority; and (13) the overall risk profile and performance of the institution. See SR-95-51 for specific guidance on rating the adequacy of risk-management processes and internal controls.

Provide the risk-management rating and discuss the risk factors and the adequacy of risk

management associated with the risk levels and risk trends. Also discuss the impact of specialty areas on relevant risk areas. For example, discuss the impact of any information technology concerns on operational and other relevant risks, as well as what impact any findings on fiduciary activities or compliance concerns have on legal and other risks. The section should discuss the management and risk-management analysis and “R” rating assignment for the bank holding company RFI/C(D) rating, as well as the examiner’s risk management-conclusions about the bank holding company.

## Risk Assessment Matrix

<i>Type of risk</i>	<i>Inherent risk</i>	<i>Adequacy of risk management</i>	<i>Composite risk</i>	<i>Trend</i>
Credit	Moderate	Weak	Moderate	Increasing
Market	Low	Weak	Low	Stable
Liquidity	High	Strong	Moderate	Decreasing
Operational	Low	Acceptable	Low	Stable
Legal	Low	Acceptable	Low	Stable
Reputational	Low	Acceptable	Low	Stable

## Risk Assessment Matrix

The inclusion of a risk matrix is optional under the Management/Administration and Risk Management content heading. A risk assessment matrix may be included either in the Management/Administration and Risk Management section or in the Examination Conclusions and Comments section, if appropriate. If not included in the open section of the report, the risk assessment matrix must be included in the confidential section of the report. The following is an example illustration:

## Analysis of Financial Factors

The content heading or report page is mandatory. It is to be included as a separate section and should include all analyses and conclusions for each financial component. Subheadings are to be used to depict the ratings and the analysis of the individual components and other topics of discussion. The order is optional. However, the more significant issues should be addressed at the beginning of this analysis. In addition to the CAELS components listed below, the bank holding company RFI/C(D) rating system component analysis should be reported in this section, if applicable. Financial tables and graphs are optional. They may also be included in an appendix.

1. *[C]apital adequacy.* Capital adequacy should be evaluated in relation to supervisory guidelines, the nature and extent of risks to the bank, and the ability of management to address and control these risks to the organization. Consideration is to be given to (1) the level of, quality of, and changes in capital and the bank’s overall financial condition; (2) the nature, trend, and volume of problem assets and the adequacy of

the allowance for loan losses and other valuation reserves; (3) risk exposures, including those presented by off-balance-sheet activities; (4) the quality and strength of earnings; (5) the balance sheet’s composition, including the nature and amount of intangible assets, market risk, concentration risk, and nontraditional-activity risk; (6) equity maintenance and any growth experiences, plans, and prospects; (7) the reasonableness of dividends; (8) the access to capital markets and other appropriate sources of financial assistance; and (9) the ability of management to address emerging needs for additional capital.

2. *[A]sset quality.* Asset quality should be evaluated in relation to (1) the level, distribution, severity, and trend of problem, classified, delinquent, nonaccrual, nonperforming, and restructured assets, both on- and off-balance-sheet; (2) the adequacy of the allowance for loan and lease losses and other valuation reserves (including the adequacy of the bank’s methodology and written documentation policies, procedures, and practices); (3) management’s awareness of problem loans and their causes and its demonstrated ability to identify, administer, and collect prob-

lem assets; (4) the diversification and quality of loan and investment portfolios; (5) the adequacy of loan-administration and lending policies, procedures, and practices; (6) the adequacy of workout procedures for problem credits; (7) the quality of investment securities and the adequacy of investment policies, procedures, and practices; (8) the extent of securities underwriting activities and exposure to counterparties in trading activities; (9) the credit risk that is arising from, or reduced by, off-balance-sheet transactions; (10) asset concentrations (including those assets, problem credits, and other transfer-risk problems in particular economic sectors); (11) the volume and nature of documentation exceptions; (12) the effectiveness of credit-administration procedures, underwriting standards, risk-identification practices, internal controls, internal loan-review and credit-grading systems (including noted significant differences between the internal loan grades and the examination's loan classifications), and management information systems; and (13) the adequacy of policies, procedures, and practices involving financial futures and foreign-exchange trading.

3. *[E]arnings.* The quality and quantity of earnings should be evaluated in relation to (1) the ability to provide for adequate capital through retained earnings; (2) the level, quality (including the strength of net interest margin, the amount of noninterest income and expense, and the extent of reliance on unusual or nonrecurring gains or losses), and stability of earnings; (3) the level of, composition of, reasonableness of assumptions for, and the extent of management's control over any variances between actual results versus the budgeted projections of income and expenses in relation to the size and nature of the bank's operations; (4) the vulnerability of earnings to market-risk exposures; (5) the adequacy of provisions to the allowance for loan and lease losses and other valuation reserves; (6) the impact of extraordinary items, securities transactions, and tax effects on net income; and (7) the adequacy of budgeting systems, forecasting processes (including the reasonableness of assumptions), and management information systems.

4. *[L]iquidity.* Liquidity and asset-liability management should be evaluated in relation to (1) the trend and stability of deposits; (2) the degree of and reliance on short-term volatile sources of funds, including any undue reliance

on borrowings or brokered deposits to fund longer-term assets; (3) the availability of assets that are readily convertible to cash without undue loss; (4) the bank's ability to securitize and sell certain pools of assets; (5) the extent and ease of the bank's access to money markets and other sources of funding; (6) the adequacy of and ease of access to liquidity sources and the bank's ability to meet liquidity needs; (7) the level of securities pledged against liabilities; (8) the bank's ability to obtain borrowed funds from outside sources that are consistent with the bank's funding strategies; (9) the effectiveness of and the extent of compliance with the bank's policies and procedures for funding and managing liquidity, interest-rate risk, management information systems, and contingency-funding plans; (10) the capability of management to properly identify, measure, monitor, and control liquidity; (11) the level of diversification of funding sources, both on- and off-balance sheet; (12) the extent of the bank's asset-liability and gap-management practices; and (13) the vulnerability of the bank's funding to adverse publicity, increased reputation risk, and lowered credit ratings.

5. *[S]ensitivity to market risk.* Sensitivity to market risk reflects (1) the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect earnings or the economic value of capital; (2) the ability of management to identify, measure, monitor, and control exposures to market risk, given the bank's size, complexity, and risk profile; (3) the nature and complexity of interest-rate risk exposure arising from nontrading positions; and (4) where appropriate, the nature and complexity of interest-rate risk arising from trading and foreign operations.

*In the following optional and mandatory pages or sections, the asterisk (\*) denotes optional pages that are mandatory if circumstances relevant to the page apply.*

### *Information Technology Assessment*

The inclusion of an information technology assessment as a content heading or report page is optional.\* An information technology assessment is mandatory, however, if an information technology (URSIT) rating is assigned (see SR-00-3) or if significant supervisory concerns

exist. Information technology activities should be evaluated based on the nature and extent of information technology risks, including management processes, architecture, integrity, security, and availability. The supporting rationale for composite or component IT ratings should be included. Examiners should note whether a list of technical exceptions was provided to management. The examiner's conclusions should also be reflected in the Analysis of Financial Factors or the Management/Administration and Risk Management sections of the report, as appropriate. Any significant supervisory concerns should be reflected in the Matters Requiring Board Attention and in the Examination Conclusions and Comments section.

### *Fiduciary Activities Assessment*

The content heading or report page is optional.\* The heading or page is mandatory, however, if a trust (UITRS) or transfer-agent rating was assigned during the most recent Federal Reserve examination cycle or if significant supervisory concerns exist in these areas. Fiduciary activities should be evaluated relative to management's oversight of fiduciary activities and the nature and extent of risk that the fiduciary activities or business lines evaluated present to the institution. Management's ability to assess the risk of fiduciary products and services offered, including new products, should be evaluated. Note whether a list of technical exceptions was provided to management. The supporting rationale for any ratings assigned should be included. Conclusions should also be reflected in the Analysis of Financial Factors or the Management/Administration and Risk Management sections of the report, as appropriate. Significant supervisory concerns should be reflected in the Matters Requiring Board Attention and Examination Conclusions and Comments section.

### *Summary of Items Subject to Adverse Classification/Summary of Items Listed as Special Mention*

The content heading or report page (and the associated content) is mandatory. The topic, however, must be discussed in the examination report. The Summary of Items Subject to Adverse Classification content heading or report

page summarizes items classified by the examiner as either substandard, doubtful, or loss as of the examination date (for this page, considered the date relevant to the asset-quality review). See SR-04-9 or section 2020.1 for the June 14, 2004, interagency agreement on the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts.

A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. An asset classified Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified Loss should be promptly charged off.

Total classifications are also presented for the previous examination. Reserve Banks that are engaged in alternate-year examination programs should provide totals contained in the previous examination report prepared by the state when applicable. The examiner should also consider creating a schedule under the Asset Quality content heading or page to detail classifications from additional prior examinations if meaningful trend information is noted. The examiner should also present, in the report narrative, classification trends for certain asset categories if the analysis is meaningful.

The report format does not contain provisions for other transfer-risk problems or value-impaired assets. For the examinations of banks engaged in international lending, examiners should provide additional information to include categories for other transfer-risk problems and value-impaired assets. Adjustments are required to be made for U.S. addressees and non-U.S. addressees.



For banks with foreign activity, the distinction between U.S. and non-U.S. addressees follows the definition set forth in the instructions for the Consolidated Report of Condition: whether a customer is U.S. or non-U.S. is determined by the customer's principal address, that is, by its domicile. A U.S. address would be in the 50 states of the United States, the District of Columbia, Puerto Rico, or U.S. territories and possessions. Non-U.S. addressees include all other geographical areas.

The examiner should list in the appropriate category the amounts of all credits classified due to transfer risk. The value of credits shown as value impaired should be computed after deducting any allocated transfer-risk reserve that is established against an asset. In determining total classified assets, examiners should arrive at net assets classified due to country risk. Examiners should identify any credits classified due to transfer risk that have received the same or a more severe classification due to credit risk and that are listed above in the summary of classified items due to credit risk. The sum of such assets should be listed in the appropriate column and then deducted to arrive at net assets classified due to country risk. For the purpose of this content heading or report page, any credits classified as value impaired for transfer-risk purposes should not be included in the summary of credits classified due to credit risk, unless the credits are classified loss.

For the purpose of arriving at total classified assets, add the amount classified due to credit risk to net assets classified due to transfer risk for each category. When computing weighted classifications, the residual portion of any value-impaired assets should be assigned the same weight as substandard classifications. However, the residual exposure still remains value impaired for examination and classification purposes. Value-impaired assets held in the trading account should also be included in total classified assets but should not be considered classified assets when computing weighted classifications.

### *Summary of Items Listed as Special Mention*

The content heading or report page (and the associated content) is mandatory. The topic must be discussed in the examination report. The Summary of Items Listed for Special Mention content heading or report page presents the

total of assets listed for special mention for the current and one previous examination. A special-mention extension of credit is defined as having potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may, *at some future date*, result in the deterioration of the repayment prospects for the credit or the institution's credit position. Special-mention credits are not considered as part of the classified-extensions-of-credit category and do not expose an institution to sufficient risk to warrant classification. The summary does not include assets listed for special mention when computing classification ratios. Reserve Banks that are engaged in alternate-year examination programs should rely on the special-mention total from the previous state's examination when applicable.

### *Loans and Lease-Financing Receivables/Past-Due and Nonaccrual Loans and Leases*

The content heading or report page (and the associated content) is optional. The examiner has the flexibility to use the same or different dates for the Loans and Lease-Financing Receivables and the Past-Due and Nonaccrual Loans and Leases schedules. The Loans and Lease Financing Receivables schedule will usually be as of the most recent quarter-end. The Past-Due and Nonaccrual Loans and Leases schedule will usually be as of the asset-quality review date. On the basis of the examination's findings, the examiner-in-charge should determine if other as-of dates best reflect the condition of the institution. For example, the Loans and Lease-Financing Receivables schedule may be presented as of the asset-quality review date if the examiner identifies significant changes since the last quarter-end that need to be incorporated.

The format of the Loans and Lease-Financing Receivables schedule is similar to that used in the Consolidated Report of Condition. The definitions of the loan categories as presented in the Instructions for the Consolidated Report of Condition should be used in completing the schedule. For examinations of banks engaged in international lending, Reserve Bank examiners should adjust the format of this schedule for U.S. addressees and non-U.S. addressees. For examinations of banks engaged in international lending, Reserve Bank examiners should adjust the format of the Past-Due and Nonaccrual Loans

and Leases schedule for U.S. addressees and non-U.S. addressees. The definitions of past-due and nonaccrual loans and leases as presented in the Instructions for the Consolidated Report of Condition should be used in completing this schedule, unless the bank's policy is more conservative, in which case the bank's definition may be used. If so, or if state law requires the bank to apply different definitions, the examiner should discuss the bank's policy or state law in the Comments section following the past-due and nonaccrual schedule. The Memorandum section should include the amount of restructured loans and leases included in the totals. Relevant issues pertaining to past-due and nonaccrual loans and leases should be briefly discussed in the Comments section. More-significant issues should be discussed on the Asset Quality page.

### *Items Subject to Adverse Classification*

The content heading or report page is optional.\* However, a full loan write-up is mandatory for all significant or material classified assets if (1) management disagrees with the disposition accorded by the examiner or (2) the institution will be rated composite 3, 4, or 5. (See SR-99-24 or section 2060.1 for further information.)

### *Items Listed for Special Mention*

The content heading or report page is optional.\* However, a full loan write-up is mandatory for all significant or material criticized assets if (1) management disagrees with the disposition accorded by the examiner or (2) the institution will be rated composite 3, 4, or 5. (See SR-99-24 or section 2060.1 for further information.)

### *Assets with Credit-Data or Collateral-Documentation Exceptions*

The content heading or report page is optional.\* However, the content heading and a discussion of any supervisory issues and concerns is mandatory if the information needed for loan line sheets is not available or if the information is not reliable due to materially deficient loan-administration systems and processes, particularly with respect to loan and collateral documentation and collateral values. (See SR-99-25

or section 2080.1 for further information.) If the credit-data or collateral-documentation exceptions are significant, this content heading or report page should provide support for a discussion of credit-documentation practices under the asset-quality portion of the Asset Quality content heading or report page.

### *Concentrations*

The content heading or report page (and its associated content) is optional.\* If included, the content heading should include a discussion of supervisory issues and concerns regarding any significant concentrations of assets and liabilities. This discussion should address the effectiveness of the bank's internal policies, systems, and controls to identify, monitor, and manage the risk associated with the concentrations and address the bank's alternatives or plans for reducing concentrations.

The content heading or report page should indicate that a concentration includes obligations, direct or indirect, of the same or affiliated interests that represent 25 percent or more of the bank's capital structure. The reader should also be informed that, for the purposes of this page, the capital structure is defined as tier 1 capital plus the allowance for loan and lease losses.

When determining and calculating concentrations, the amount of loan commitments and other off-balance-sheet risk items should be considered. The listing should include all types of loans, overdrafts, cash items, suspense resources, securities, leases, acceptances, advances, letters of credit, and all other items due to the bank, as well as loans endorsed, guaranteed, or cosigned by related individuals and their related interests.

Concentrations by industry, transfer risk, product line, type of collateral, and other characteristics should be detailed when appropriate. The listing should include amounts due from depository institutions, federal funds sold, and other assets in which payment depends on one financial institution or affiliated group and the total represents 25 percent or more of the bank's capital structure. Treasury securities, obligations of U.S. government agencies and corporations, and any assets collateralized by these items should not be included in the listing. The requirements of Regulation F, as they relate to concentrations involving correspondent banks, should also be considered.

### *Violations of Laws and Regulations*

The content heading or report page is optional.\* However, when violations of federal or state banking laws and regulations are found, it is mandatory that they be listed in detail on this page. Violations of the Bank Secrecy Act should also be listed on this page in detail.

The format for listing violations should be consistent. A heading for each violation listed should name the applicable regulation and section and provide a brief description of what the law covers. This summary should be followed by a brief description of the requirements of the regulation or statute and a discussion of how or why the violation occurred. The examiner should describe any plans or recommendations for correction. If a review of the Bank Secrecy Act is conducted separately, or as part of another examination, a statement of this fact should be included under the Other Matters content heading or report page.

### *Other Matters*

This content heading or report page is optional. If included, discuss issues or other matters of significance not covered elsewhere in the community bank's examination report. Discuss also significant matters mentioned elsewhere that require further explanation, such as the type, scope, and volume of any new activity in which the bank is engaged. If issues or concerns are noted, examiners should provide comments on such specific areas, such as the following:

- accounting, audit, and internal controls
- affiliate relationships
- criminal referral procedures
- emergency preparedness
- financial recordkeeping and reporting regulations
- insurance
- investment in bank premises
- litigation
- security and controls against external crimes
- payments system risk
- nontraditional banking activities (for example, mortgage warehousing or data processing services)
- supervisory reporting
- nondeposit investment products

Other examination matters may also warrant comments on this report page.

### *Comparative Statement of Financial Condition*

The Comparative Statement of Financial Condition page is mandatory. Alternatively, the statement may be included in an appendix to the examination report or in the confidential section. The left column of the statement should coincide with the Consolidated Report of Condition for the period used—generally, the most recent quarter-end. If Call Report amendments have been made, the amended numbers should appear on this page. If a bank's management has made any significant misclassifications that have caused examiners to amend any financial statements, the examiner's numbers should appear on this page. The right column should usually detail previous year-end information. However, the examiner may substitute a different date, such as a previous examination, when desired. All amounts listed in either column should conform to Consolidated Report of Condition instructions.

### *Comparative Statement of Income*

The comparative statement of income is mandatory. Alternatively, the statement may be included in an appendix to the report or in the confidential section. The examiner should indicate whether the statement is for the institution only or is consolidated.

### *Capital Calculations*

The Capital Calculations page is optional.\* Inclusion of capital calculations is mandatory, however, if (1) the bank has a financial subsidiary within the meaning of the Gramm-Leach-Bliley Act, (2) there is a change in the capital category as a result of the examination, or (3) the ratios supporting the capital category in the examination are not derived from the bank's Call Report as of the same date. The third exception could occur if the bank's examination ratios were calculated at a date other than the end of a quarter, or, if calculated at quarter-end, the numbers were adjusted or changed from those filed in the Call Report.

### *Other Financial Pages*

Other optional financial report content headings

or report pages may be included in the examination report at the examiner's discretion. Alternatively, the content headings or report pages may be included in an appendix to the examination report or in the report's confidential section.

### *Signature of Directors*

The content heading is mandatory. A separate report page is required and should be the last page in the open section of the report.

### **Confidential Section**

"Confidential Section" is a required content heading. This section of the bank examination report is mandatory. It must include all information that cannot or should not be disclosed or made available to the public. It should also include internal administrative and supervisory information relevant to the Federal Reserve System and its staff. The order of the following headings or pages is at the examiner's discretion.

### *Directors and Officers*

The content heading or report page is mandatory for inclusion in the report. A separate report page is required. All bank directors should be listed in alphabetical order. If the bank elects advisory directors, they should be listed alphabetically under a separate heading. Information requested in the report-page header should be supplied for each director. Specific instructions for certain requested information are as follows:

- Under meetings missed, include all meetings a director has not attended between the previous (FRB or state) and current examination. If a director was elected since the previous examination, list only the number of meetings that he or she missed since the date of election.
- Under fees paid to each director, indicate whether the compensation is based on attendance.
- Under occupation or principal business affiliation, use concise and descriptive designations (for example, farmer, grocer, or commercial real estate developer).

For banks with active board committees, a code or legend for all committees should be prepared, indicating committee memberships for each director.

The Executive Officers portion of the report page uses the Regulation O definition of executive officers, but other significant officers may be included at the examiner's discretion. Information requested by the report page should be supplied. Additional individuals to be reported may include persons without official designation who exercise considerable influence or executive officers excluded from the Regulation O definition by board resolution who actually maintain a high level of responsibility. Officers should be listed in order of title or position of responsibility, with dominant individuals shown first. Specific instructions for the requested information for the report page are as follows:

- Examples of assigned areas of responsibility may include administration, policy formulation, lending, operations, or branch manager.
- A salary should indicate the current annual salary. The total bonuses should be reported for the previous year.

If executive officers receive any other pertinent forms of compensation beyond their listed salary and bonus (such as commission-based pay, employment contracts, stock options, unusually large benefits, or affiliated bank salaries and fees), these should be discussed in narrative format below the listing of executive officers or on a separate page.

### *General Information*

The content heading is mandatory. It includes (1) a discussion of strategic plans, future technology plans, planned bank products or services, or prospects for the bank; (2) significant or sensitive matters regarding the bank's management not previously addressed; (3) applicable comments on the extent that a particular insider controls or dominates the organization and any adverse effect of insiders on operating policies, procedures, or the overall financial condition of the bank; and (4) a discussion of any recommendations for supervisory actions and any additional material matters of a sensitive or confidential nature not previously addressed. To the extent not included on the Directors and Officers page, this discussion should also include a list of

each of the major shareholders of the bank (those having 5 percent or more ownership) and their respective percentage of ownership. When the major shareholder is a bank holding company, its major shareholders and the percent controlled by each should also be listed. Include a listing of critical turnkey software vendors or

information technology service providers, as well as any client institutions for which processing services are provided. Include any significant matters of a confidential nature regarding vendors or third-party service providers. Also include a description of any electronic banking activities.

Example State Member Bank  
Examination Report for  
Community Banks  
(Instructions Included)

REPORT OF COMMERCIAL BANK EXAMINATION

Lead Bank Name \_\_\_\_\_ Street Address \_\_\_\_\_ City \_\_\_\_\_

County \_\_\_\_\_ State \_\_\_\_\_ Zip Code \_\_\_\_\_  
 Mailing Address: \_\_\_\_\_

\_\_\_\_\_ Joint \_\_\_\_\_ Concurrent \_\_\_\_\_ Independent

\_\_\_\_\_ Federal Reserve Bank Examiner-In-Charge

TABLE OF CONTENTS

(Order of content is dependent upon importance and significance of the issues)

Page

Mandatory Content

Scope / Matters Requiring Board Attention and Examination Conclusions and  
 Comments..... \*

Analysis of Financial Factors..... \*

Management / Administration and Risk Management..... \*

Summary of Items Subject to Adverse Classification /  
 Summary of Items Listed as Special Mention ..... \*

Comparative Statement of Financial Condition ..... \*

Comparative Statement of Income ..... \*

Signature of Directors..... \*

(Confidential Section)

(Directors and Officers) ..... \*

(General Information) ..... \*

Optional Content

Compliance with Enforcement Actions ..... \*\*

Information Technology Assessment..... \*\*

Fiduciary Activities Assessment ..... \*\*

Loans and Lease-Financing Receivables /  
 Past Due and Nonaccrual Loans and Leases ..... \*\*

Items Subject to Adverse Classification..... \*\*

Items Listed for Special Mention ..... \*\*

Assets with Credit-Data or Collateral-Documentation Exceptions ..... \*\*

Concentrations ..... \*\*

Violations of Laws and Regulations..... \*\*

Other Matters ..... \*\*

Capital Calculations..... \*\*

Other Financial Pages ..... \*\*

Note: Except as indicated, amounts in tables are shown to the nearest thousand dollars.

Date of previous Examination:

\* Mandatory Content

\*\* Optional Content (However, some content is mandatory if circumstances relevant to the issue apply.)

SCOPE / MATTERS REQUIRING BOARD ATTENTION  
AND EXAMINATION CONCLUSIONS AND COMMENTS

SCOPE

Comment on the examination's depth, scope, and procedures performed for each area of review, including any specialty areas.

MATTERS REQUIRING BOARD ATTENTION

State if there are any matters requiring board of director's attention, including significant issues from specialty examination areas, as applicable.

EXAMINATION CONCLUSIONS

Provide all supervisory ratings assigned during the examination and for the two previous examinations, any significant supervisory concerns, and general conclusions. Include any specialty or target examination ratings assigned or other assessments, including findings from other on-site visits during the recent Federal Reserve examination cycle.

	<u>Exam Date</u> mm/dd/yyyy	<u>Prior Exam</u> mm/dd/yyyy	<u>Prior Exam</u> mm/dd/yyyy
Uniform Composite Rating – Bank	X	X	X
Component Ratings:			
[C]apital	X	X	X
[A]sset Quality	X	X	X
[M]anagement	X	X	X
[E]arnings	X	X	X
[L]iquidity	X	X	X
[S]ensitivity to Market Risk	X	X	X
Risk Management	X	X	X
Bank Holding Company RFI/C (D) Rating			
[R]isk Management	X	X	X
[F]inancial Condition	X	X	X
[I]mpact Potential	X	X	X
[C]omposite Rating	X	X	X
[D]epository Institutions	X	X	X
Other examination area ratings (if applicable):	<u>Date of Examination</u>		<u>Composite Rating</u>
Trust	mm/dd/yyyy		X
Compliance	mm/dd/yyyy		X
CRA	mm/dd/yyyy		X



SCOPE / MATTERS REQUIRING BOARD ATTENTION  
AND EXAMINATION CONCLUSIONS AND COMMENTS

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UNIFORM COMPOSITE RATING

Bank

BHC

Other

---

Examiner-In-Charge's  
Signature

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Page X of Y

## ANALYSIS OF FINANCIAL FACTORS

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Include analysis and conclusions for each financial component in this section using subheadings to depict ratings and analysis of individual components and other topics of discussion. The order is optional; however, the more significant issues should be addressed up front. In addition to the CAELS components listed below, the Bank Holding Company Rating component analysis should be written in this section, if applicable. Financial tables and graphs may be included on this page or in an appendix.

### Asset Quality ( )

Asset quality is considered \_\_\_\_

### Liquidity Position ( )

The bank's liquidity position and funds management are \_\_\_\_.

### Sensitivity to Market Risk ( )

Interest rate risk (IRR) management is \_\_\_\_\_ and exposure to market risk is \_\_\_\_\_.

### Capital Adequacy ( )

The bank's capital position is \_\_\_\_\_.

### Earnings ( )

Earnings performance is \_\_\_\_\_.

**MANAGEMENT / ADMINISTRATION  
AND RISK MANAGEMENT**

The management and risk management analysis, rating, and conclusion for the bank and holding company, if applicable, should be included in this section.

Management (X)

Management is X.

Risk Management (X)

Mandatory Risk Management Assessment - Provide the risk management numerical rating and discussion of risk factors and the adequacy of risk management associated with risk levels and risk trends. The impact of specialty examination areas on relevant risk areas should be incorporated. For example, the impact of any information technology concerns on operational and other relevant risks should be discussed, as well as the impact on legal or other risks of any findings with respect to fiduciary activities or compliance concerns.

Risk Management is X.

Optional Risk Assessment Matrix - A risk assessment matrix may be included either in the Management/Administration and Risk Management section or in the Examination Conclusions and Comments section, as appropriate.

**Risk Assessment Matrix (Optional)**

Type of Risk	Inherent Risk	Adequacy of Risk Management	Composite Risk	Trend
Credit	Moderate	Weak	Moderate	Increasing
Market	Low	Weak	Low	Stable
Liquidity	High	Strong	Moderate	Decreasing
Operational	Low	Acceptable	Low	Stable
Legal	Low	Acceptable	Low	Stable
Reputational	Low	Acceptable	Low	Stable

Credit Risk (Mandatory)

Market Risk (Mandatory)

Liquidity Risk (Mandatory)

Operational Risk (Mandatory)

Legal Risk (Mandatory)

Reputational Risk (Mandatory)

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SUMMARY OF ITEMS SUBJECT TO ADVERSE CLASSIFICATION /  
 SUMMARY OF ITEMS LISTED AS SPECIAL MENTION

Asset Category	Adversely Classified Categories			Total Classifications
	Substandard	Doubtful	Loss	
Loans/Leases	\$			
Securities	\$			
Other Real Estate Owned	\$			
Other Assets	\$			
Totals at This Exam <i>date</i>	<u>\$</u>	<u></u>	<u></u>	<u></u>
Totals at Prior Exam <i>date</i>	<u>\$</u>	<u></u>	<u></u>	<u></u>

SUMMARY OF ITEMS LISTED FOR SPECIAL MENTION

Loans/Leases

\$

COMPARATIVE STATEMENTS OF FINANCIAL CONDITION

(Amounts Reported in Thousands)

	mm/dd/yyyy	mm/dd/yyyy
<b>ASSETS</b>		
Total Loans and Leases		
Less: Allowance for Loan & Lease Losses		
Loans and Leases (net)		
Interest-Bearing Balances		
Federal Funds Sold and Securities Purchased		
Under Agreements to Resell		
Trading Account Assets		
Securities: Held-to-Maturity (at Amortized Cost)		
Available-for-Sale (at Fair Value)		
<b>Total Earning Assets</b>		
Cash and Noninterest-Bearing Balances		
Premises and Fixed Assets		
Other Real Estate Owned		
Intangible Assets		
Other Assets		
<b>TOTAL ASSETS</b>		

<b>LIABILITIES AND EQUITY CAPITAL</b>		
Deposits		
Federal Funds Purchased and Securities Sold		
Under Agreements to Repurchase		
Other Borrowed Money		
Other Liabilities		
Subordinated Notes and Debentures		
<b>Total Liabilities</b>		
Equity Capital		
Perpetual Preferred Stock		
Common Equity Capital		
<i>Includes net unrealized holding gains (losses) on available-for-sale securities.</i>		
Other Equity Capital		
<b>Total Equity Capital</b>		
<b>TOTAL LIABILITIES AND EQUITY CAPITAL</b>		

<b>OFF-BALANCE-SHEET ITEMS</b>		
Unused Loan Commitments		
Letters of Credit		
Interest Rate Contracts		
Appreciation (Depreciation) in Held-to-Maturity Securities		
Other Off-Balance-Sheet Items		

Footnotes:

COMPARATIVE STATEMENT OF INCOME		(Amounts reported in \$ thousands)		
ITEMS	mm/dd/yyyy	mm/dd/yyyy	mm/dd/yyyy	
<b>INTEREST INCOME:</b>				
Interest and fee income on loans				
Income from lease financing				
Interest on balances with depository institutions				
Income on Federal funds sold and repos				
Interest from assets held in trading accounts				
Interest and dividends on:				
U.S. government securities				
Obligations of states and political subdivisions				
Other securities				
<b>TOTAL INTEREST INCOME</b>				
<b>INTEREST EXPENSE:</b>				
Interest on deposits				
Expense on Federal funds purchased and repos				
Interest on demand notes, other borrowed money, mortgages, and capitalized leases				
Interest on subordinated notes and debentures				
<b>TOTAL INTEREST EXPENSE</b>				
<b>NET INTEREST INCOME</b>				
<b>NONINTEREST INCOME:</b>				
Services charges on deposit accounts				
Other fee income				
All other noninterest income				
<b>TOTAL NONINTEREST INCOME</b>				
<b>NONINTEREST EXPENSE:</b>				
Salaries and employee benefits				
Premises and fixed assets expense (net of rental income)				
Other noninterest expense				
<b>TOTAL NONINTEREST EXPENSE</b>				
Provision for loan and lease losses				
Provision for allocated transfer risk				
Securities gains (losses)				
<b>NET OPERATING INCOME (PRETAX)</b>				
Applicable income taxes				
<b>NET OPERATING INCOME (AFTERTAX)</b>				
Extraordinary credits (charges) net of income tax				
<b>NET INCOME</b>				
Cash dividends declared on common stock				
Other increases or decreases				
<b>NET CHANGE IN EQUITY ACCOUNTS</b>				

COMPARATIVE STATEMENT OF INCOME

(Amounts reported in \$ thousands)

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Footnotes:

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**CONFIDENTIAL  
SECTION**

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CONFIDENTIAL SECTION  
 DIRECTORS AND OFFICERS

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Name & Committees Address Year of Birth	Meetings Missed <sup>1</sup>	Years on Board	Shares Owned	Compensation (Bonus)	Occupation or Principal Business Affiliation
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Chairman

Directors

Principal Officers

*Insert statements on qualifications of individual officers and directors as appropriate.*

Regular schedule of directors' meetings:

Fee paid each director:

Committees:

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<sup>1</sup> Number of meetings missed out of a total of X held since X

CONFIDENTIAL SECTION  
GENERAL INFORMATION

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Include a discussion of strategic plans, future technology plans, planned bank products or services, and/or prospects for the bank; significant or sensitive matters regarding the bank's management not previously addressed; applicable comments on the extent a particular insider controls or dominates the organization and any adverse effect of insiders on operating policies, procedures, or overall financial condition of the bank; and a discussion of any recommendations for supervisory actions and any additional material matters of a sensitive or confidential nature not previously addressed. To the extent not included on the Directors and Officers page, this discussion should also include a list of each major shareholder of the bank (5 percent or more) and the respective percentage of ownership. When the major shareholder is a bank holding company, its major shareholders and the percent controlled should be listed. Include a listing of critical turnkey software vendors, and/or service providers, and any client institutions for which processing services are provided. Include any significant matters of a confidential nature regarding vendors or third-party service providers. In addition, include a listing of e-banking activities.

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OPTIONAL PAGES

COMPLIANCE WITH ENFORCEMENT ACTIONS

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## INFORMATION TECHNOLOGY ASSESSMENT

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Mandatory if an Information Technology (URSIT) rating is assigned (refer to SR 00-3 for details) or if significant supervisory concerns exist. Information technology activities should be evaluated based upon the nature and extent of information technology risks including management processes, architecture, integrity, security and availability. Supporting rationale for composite and/or component IT ratings should be included. Note whether a list of technical exceptions was provided to management. Conclusions should also be reflected in Analysis of Financial Factors and/or the Management/Administration and Risk Management sections of the report, as appropriate, and any significant supervisory concerns should be reflected in the Matters Requiring Board Attention and Examination Conclusions section.

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## FIDUCIARY ACTIVITIES ASSESSMENT

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Mandatory if a Trust (UITRS) or transfer agent rating is assigned during the most recent Federal Reserve examination cycle or if significant supervisory concerns exist in these areas. Fiduciary activities should be evaluated relative to management's oversight of fiduciary activities and the nature and extent of risk to the institution represented by the fiduciary activities or business lines evaluated. Management's ability to assess the risk of fiduciary products and services offered, including new products, should be evaluated. Note whether a list of technical exceptions was provided to management. Supporting rationale for any ratings assigned should be included. Conclusions should also be reflected in Analysis of Financial Factors and/or the Management/Administration and Risk Management sections of the report, as appropriate, and any significant supervisory concerns should be reflected in the Matters Requiring Board Attention and Examination Conclusions and Comments section.

LOAN AND LEASE FINANCING RECEIVABLES/  
PAST DUE AND NONACCRUAL LOANS AND LEASES

Date: \_\_\_\_\_

<u>Category</u>	<u>Amount</u>	<u>Percent</u>
Real estate loans		
Installment loans		
Credit card and related plans		
Commercial loans		
All other loans and leases		
Gross loans and leases	<u>\$</u>	<u>100.00%</u>

PAST DUE AND NONACCRUAL LOANS AND LEASES

Asset Category	Past Due Amount		Total Past Due		Nonaccrual		Total Past Due and Nonaccrual	
	30 - 89 Days	90 Days or More	Amount	Percent	Amount	Percent	Amount	Percent
Real estate loans								
Installment loans								
Credit card and related plans								
Commercial loans and all other loans and leases								
Totals								

Memorandum:

Restructured loans and leases included in the above totals.

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Comments:



## ITEMS SUBJECT TO ADVERSE CLASSIFICATION

Includes assets and off-balance-sheet items which are detailed in the following categories:

**Substandard Assets** - A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful Assets** - An asset classified Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

**Loss Assets** - An asset classified Loss is considered uncollectible and of such little value that continuance as a bankable asset is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified loss should be promptly charged off.

Amount, Description, and Comments	Classification Category		
	Substandard	Doubtful	Loss

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**ITEMS LISTED FOR SPECIAL MENTION**

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Includes assets and off-balance-sheet items which are detailed as follows:

Special Mention Assets - A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may, at some future date, result in the deterioration of the repayment prospects for the asset or in the institution's credit position. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

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Description	Amount
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### ASSETS WITH CREDIT-DATA OR COLLATERAL-DOCUMENTATION EXCEPTIONS

Includes assets with technical defects not corrected during the examination for which deficiency the appropriate number or description is noted in the "Deficiency" column.

- |                                   |                           |
|-----------------------------------|---------------------------|
| 1 – Appraisal                     | 6 – Collateral Assignment |
| 2 – Title Search or Legal Opinion | 7 – Financial Statement   |
| 3 – Borrowing Authorization       | 8 –                       |
| 4 – Recordation                   | 9 –                       |
| 5 – Insurance                     | 10 –                      |

Name or Description	Amount	Date of Most Recent Financial Statement	Deficiency Description

CONCENTRATIONS

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VIOLATIONS OF LAWS AND REGULATIONS

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OTHER MATTERS

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CAPITAL CALCULATIONSTier 1 Capital \$(000's)    \$(000's)

Common Stock

Surplus

Undivided Profits and Capital Reserves

*Does not include appreciation (depreciation) on held-to-maturity and available-for-sale securities*

Noncumulative Perpetual Preferred Stock &amp; Surplus

Minority Interests

Subtotal: Tier 1 Capital Elements

Add:

Less:

Tier 1 Capital

Tier 2 Capital

Allowance for Loan &amp; Lease Losses

Add:

Adjusted Allowance for Loan &amp; Lease Losses

Less:

Eligible Allowance for Loan &amp; Lease Losses

Cumulative Perpetual Preferred Stock

Subordinated Debt

Other:

Tier 2 Capital (Not to Exceed 100% of Tier 1 Capital)

Total Capital

Tier 1 Plus Tier 2 Capital

Less :

Total Capital

Risk-Weighted Assets and Average Total Assets Calculations

Risk-Weighted Balance-Sheet Items

Risk-Weighted Off-Balance-Sheet Items

Less: Risk-Weighted Amounts Deducted from Capital

Gross Risk-Weighted Assets

Less: Ineligible Portion of ALLL &amp; ATRR

Total Risk-Weighted Assets

Average Total Assets (From 01/01/\_\_\_ Call Report)

Less: Amounts Deducted from Tier 1 Capital

Adjusted Average Total Assets

## MEMORANDA

Securities Appreciation (Depreciation)

Contingent Liabilities/Potential Loss

Footnotes:

OTHER FINANCIAL INFORMATION

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This section deals specifically with Federal Reserve System policies, practices, and procedures relating to the examination of domestic and international banking departments of state-chartered commercial banks that are members of the Federal Reserve System. The Federal Reserve also has certain supervisory and oversight responsibilities in other areas of banking, both domestic and international, for which it has developed specialized examination procedures, conducts on-site examinations, and completes separate examination reports. These areas are not covered in depth in this manual; Federal Reserve policies and examination procedures relating to each of them are covered in either separate manuals or supervisory letters (SR-letters) issued by the Federal Reserve Board.

### BANK HOLDING COMPANIES

The Federal Reserve has the sole regulatory responsibility for supervising bank holding companies (BHCs). These organizations control commercial banks that hold most of the insured commercial banking assets in the United States. Substantially all BHCs may be subject to an on-site inspection by the Federal Reserve System. The frequency and scope of inspections are determined by the composite rating, asset size, amount of debt, and complexity of the organization. Inspections cover both financial and managerial factors and include analysis at the parent, bank, nonbank, and consolidated levels.

### INTERNATIONAL

#### Overseas Operations of U.S. Banking Organizations

Under provisions of the Federal Reserve Act and the Board's Regulation K, member banks may establish branches in foreign countries subject to, in most cases, the Board's prior approval. Furthermore, section 25 of the Federal Reserve Act permits the Board to order special examinations of foreign banks or branches as it may deem best. However, the Federal Reserve's examinations of state member banks' overseas operations and activities are usually conducted

at the head office in the United States, where the ultimate responsibility for the overseas activities and facilities may lie. To adequately supervise international operations, examiners and supervisory staff should continuously monitor the bank's international activities to understand and assess the extent of its international strategy, trends, operations, and legal-entity structure, as well as related governance, risk management, and internal controls. Additional information regarding the consolidated supervision of international operations of U.S. banking organizations can be found in sections 1050.1 and 1050.2 of the *Bank Holding Company Supervision Manual* and in the attached guidance to SR-08-9, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations."

#### Edge Act and Agreement Corporations

Under sections 25 and 25A of the Federal Reserve Act, Edge Act and agreement corporations may engage in international banking and foreign financial transactions, and the Federal Reserve is responsible for conducting examinations of these entities and their branches. Edge corporations are chartered by the Board to conduct an international banking business. Agreement corporations are state-chartered companies that enter into an agreement with the Board to limit their operations to international banking. These corporations, which are usually subsidiaries of member banks, provide their owner organizations with additional powers in two areas: (1) they may conduct a deposit and loan business in states other than that of the parent, provided that the business is strictly related to international transactions and (2) they have somewhat broader foreign-investment powers than member banks, being able to invest in foreign financial organizations, such as finance companies and leasing companies, as well as in foreign banks.

#### U.S. Activities of Foreign Banking Organizations

Foreign entities have rapidly expanded their operations in the United States and are a signifi-

cant element in the U.S. banking system. The Federal Reserve has significant authority over foreign banking organizations (FBOs). Its role was enhanced by the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA). The Federal Reserve has broad oversight authority for the supervision and regulation of FBOs that engage in banking in the United States through branches, agencies, commercial lending companies, and subsidiary banks. In fulfilling this responsibility, the Federal Reserve conducts its own examinations and may also use reports of other agencies. (See SR-96-36.) FBSEA also requires Federal Reserve approval for establishment of new FBO offices in the United States, and it gives the Federal Reserve the authority to terminate such offices.

## ELECTRONIC DATA PROCESSING ACTIVITIES

The Federal Reserve is responsible for conducting examinations of electronic data processing (EDP) centers that provide EDP services to state member banks, FBOs, and Edge Act corporations. Section 3 of the Bank Service Corporation Act (12 USC 1863, redesignated as the Bank Service Company Act) generally authorizes bank service companies to perform significant clerical, bookkeeping, or accounting functions, such as demand-deposit accounting and loan processing. Section 7 of the Bank Service Company Act (12 USC 1867) empowers the appropriate federal regulatory agency to examine banking services and operations regardless of whether these services are performed on or off the premises of a particular financial institution. When a financial institution contracts with an external company to provide data processing services, the data processing company's activities that pertain to financial institutions are subject to examination. Larger companies that operate in more than one regulatory district or region are examined pursuant to the Multiregional Data Processing Servicer (MDPS) examination program. EDP examinations, whether of independent processing companies or a state member bank's own EDP functions, are operational in nature and focus on evaluations of internal controls and audit effectiveness. EDP examiners have specialized training that enables them to assess the performance of each data center in four critical functions: audit, management, systems development and programming, and computer operations.

## TRUST DEPARTMENTS AND TRUST COMPANIES

The Federal Reserve examines trust departments of state member banks, trust companies that are members of the Federal Reserve System, and certain nondepository trust company subsidiaries of BHCs. These examinations determine whether the trust functions are conducted in accordance with applicable fiduciary principles and with other appropriate laws and regulations.

To supplement the supervision of the increasing number of nondepository trust companies that are subsidiaries of BHCs, the Federal Reserve has instituted a program of examinations for those trust companies not supervised by any other federal banking agency. In addition, a program of limited inspections of state member banks, BHCs, and Edge Act corporations that conduct foreign fiduciary activities has been instituted.

To engage in providing trust or fiduciary services, a bank must have proper authorization under state or federal law. Under the laws of most states, this requires a specific approval of the state financial supervision agency. Similarly, pursuant to the Board's Regulation H section 208.3(d)(2), the Board's permission must be obtained before changing the general character of a bank's business.

## TRANSFER-AGENT ACTIVITIES

Transfer agents countersign and monitor the issuance of securities, register transfers of securities, and exchange or convert securities. Federal Reserve examiners conduct separate examinations of, and complete separate reports for, the transfer-agency activities of those state member banks and BHCs that are registered with the Board of Governors as transfer agents.

## MUNICIPAL SECURITIES DEALERS, GOVERNMENT SECURITIES DEALERS, AND CLEARING AGENCIES

As a result of the Securities Act Amendments of 1975, the Board is responsible for supervising state member banks and bank holding compa-

nies that act as municipal securities dealers or clearing agencies. Federal Reserve examiners conduct separate examinations of and complete separate reports for both of these activities. A bank, a separate department or division of a bank, or a bank holding company is required to register as a municipal securities dealer if it “engages in the business” of buying and selling municipal securities for its own account other than in a fiduciary capacity. Examiners should refer to SR-86-40 for examination procedures and report forms on municipal securities dealers.

The Government Securities Act of 1986 (GSA) gave the Federal Reserve responsibility for examining the government securities activities of a state member bank, foreign bank, state branch or state agency of a foreign bank, or commercial lending company owned or controlled by a foreign bank. The GSA requires all government securities brokers or dealers that were previously unregistered to register with the Securities and Exchange Commission. Brokers and dealers receive specialized examinations to determine compliance with the GSA. For banks that have a lower level of government securities activities, compliance with the GSA is determined as part of the commercial examination.

The examination procedures for the GSA are found in SR-87-37, SR-93-40, and several subsequent letters including SR-06-8. The responsible staff at the Reserve Bank conducting the examination needs to ensure that they fully consider their supervisory responsibilities under the GSA in formulating their supervisory plans and conducting risk-focused examinations. In this regard, two key factors should be considered concerning government securities custodial activities. First, all depository institutions that hold government securities for customers, including securities under repurchase agreements, are subject to Treasury’s GSA custody rules. Second, certain financial institutions that are exempt from the definition of a government securities broker or dealer are, nevertheless, subject to the Treasury government securities broker or dealer custody rules when they engage in hold-in-custody repurchase agreements. Under such agreements, the financial institution retains custody of securities that are the subject of a repurchase agreement between the financial institution and a counterparty.<sup>1</sup> These issues are

fully described in the examination procedures pertaining to government securities activities, which are referenced in SR-87-37 and SR-93-40. (See also SR-94-5, SR-90-1, and SR-88-26.)

Reserve Bank staff are to separately report to Board staff only the results of reviews of government securities broker-dealer activities (and such broker-dealer’s related custodial activities). See SR-06-8 and its attachment, which includes the instructions for the report’s transmittal. When preparing these reports, Reserve Banks have the option of either using the Summary Report of Examination of Government Securities Broker-Dealer Activities and Custodial Activities (GSB-D report) or forwarding a copy of the relevant section of the examination report that contains the same information as required in the GSB-D report.

A clearing agency acts as a custodian of securities for the settlement of securities transactions by bookkeeping entries. Separate reporting on the GSB-D form is not required for a government securities custodian that engages in hold-in-custody repurchase agreements but which is otherwise exempt from filing notice as a government securities broker or dealer. See 17 CFR 403.5(a) and (d), and SR-93-40.

## CONSUMER EXAMINATIONS

Some banking laws, such as the Truth in Lending Act and the Truth in Savings Act, require banks to disclose information that helps consumers evaluate product options open to them. Other laws (for example, the Community Reinvestment Act and the Equal Credit Opportunity Act) require banks to help meet the credit needs in their communities and promote the availability of credit to all creditworthy applicants. Finally, laws such as the Fair Credit Reporting Act and the Fair Debt Collection Act provide consumer safeguards for the extension, collection, and reporting of consumer credit. At the Federal Reserve, specialized examiners conduct examinations to determine banks’ compliance with these laws and their implementing regulations.

1. See 17 CFR 450, which governs holdings of government

securities for customers, except those held in a fiduciary capacity (17 CFR 450.3).

The international sections focus on the examination of risks and activities associated with international lending, financing instruments, and international banking. In addition to the sections that follow, information on the international aspects of cash accounts, nostro accounts, foreign collections, investments, and borrowed funds can be found in the applicable domestic sections:

- For foreign-currency cash accounts, see section 2000.1, “Cash Accounts.”
- For due from foreign banks—demand (nostro accounts) and foreign collections (cash letters, return items), see section 2010.1, “Due from Banks.”
- For foreign investments, see section 2020.1, “Investment Securities and End-User Activities.”
- For foreign governments and foreign political entities, see section 3000.1, “Deposit Accounts.”
- For international borrowed funds, see section 3010.1, “Borrowed Funds.”
- For foreign investments and foreign banking organizations, see section 4050.1, “Bank-Related Organizations.”

Additional information on international activities can be found in the *Bank Holding Company Supervision Manual*, *Trading and Capital-Markets Activities Manual*, *FFIEC Bank Secrecy Act Anti-Money Laundering Examination Manual*, and *FFIEC Information Technology (IT) Examination Handbook*.

# International—Examination Overview and Strategy

## Section 7000.1

Effective date May 2005

Generally, the basic procedures used for the examination and verification of international operations are the same as those used for other domestic bank functions. However, some procedures are modified for different types of bank assets and liabilities and contingent accounts, as well as for separate laws and regulations that may be applicable. Documentation and accounting procedures for international operations may also differ from those used in the domestic banking areas, but the same examination objectives apply. The examination process may also include a review of international banking facilities (IBFs) and periodic visits to selected foreign branches and subsidiaries to determine the safety and soundness of their operations and the adequacy of reporting procedures used by the head office or parent bank to monitor the foreign office.

The increasingly global nature of economic activities has made international banking operations more important to bank customers, importers and exporters of goods and services, and domestic customers with overseas operations who require a source of international financial assistance. As service institutions, commercial banks provide this assistance through global networks of representative offices, branches, and affiliates, as well as through correspondent relationships. These foreign networks also allow banks to offer services outside their traditional market areas. Additionally, in 1981, the Board of Governors amended regulations to allow for the establishment of IBFs in the United States. The activities of these facilities are limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institution establishing the IBF.

Many domestic banking activities are also conducted internationally, including providing cash and collection services, placing and taking deposits, making investments, granting loans and overdrafts, and borrowing. The international examiner will use the appropriate examination procedures for domestic operations when reviewing these activities. The examination procedures for the international aspects of these and other activities are covered in the following international sections.

Similarly, other activities that are primarily international are similar to activities found in the domestic banking area. For example, a confirmed letter of credit represents a formal

commitment to extend credit provided that certain collateral and documentary conditions exist. Foreign-exchange trading activities are similar to money-trading operations conducted at domestic funding desks. Foreign-exchange positions are similar to commodity inventories carried at book value that are exposed to fluctuating market prices. Separate international sections in this manual relate to these functions.

IBF activities are to be reviewed during the examination of international operations. The review of assets, internal controls, and operating procedures should be conducted using procedures similar to those used for offshore shell branches. In addition, reports required to be filed by IBFs should be reviewed to ensure that they are prepared properly and filed in a timely manner.

Additional international banking activities, such as direct lease financing, installment loans, real estate loans, real estate construction loans, ownership of bank premises and equipment, and other real estate owned are to be examined using the applicable procedures in section 2210.1, "Other Assets and Other Liabilities," and section 3020.1, "Assessment of Capital Adequacy." International examinations will also require reference to other sections of this manual. Guidelines for using these other sections in international examinations are provided below.

### WORKPAPERS

Workpapers should consist of written documentation of the examination procedures followed and of the conclusions reached during the examination of international operations. The definition, purpose, quality standards, preparation, and organization of workpapers used in international examinations are the same as those discussed in section 1030.1, "Workpapers."

### EXAMINATION STRATEGY

Careful planning and control are as important in international examinations as they are in domestic examinations. A number of the procedures found in section 1000.1, "Examination Strategy and Risk-Focused Examinations," also apply to international examinations.

When assigning work in the various examination areas, the examiner should consider the organization of the bank. For example, many banks have consolidated their foreign-exchange trading and money market operations into a single division that is responsible for the bank's global money market operations. Similar situations may be encountered for other international-related functions that are combined with domestic operations. Consequently, the examination assignments should address those situations.

In some examinations, the examiner may come across certain activities that are not addressed by any particular section of the international portion of this manual. In these instances, the examiner should extract the appropriate objectives, examination procedures, and internal control questionnaires from the domestic sections of this manual.

The examiner must be certain that all types of individual customer liabilities have been analyzed on a consolidated basis, regardless of the office where they are booked. However, since the procedures for the collection and consolidation of customer liabilities booked in overseas offices differ among banks, the examiner should determine whether the bank's procedures are adequate.

## INTERNAL CONTROL

The examiner should use section 1010.1, "Internal Control and Audit Function, Oversight, and Outsourcing," in the domestic portion of this manual to evaluate the objectives of and the work performed by internal and external auditors for the bank's international operations. The internal control section sets forth general criteria to be considered in evaluating the work of internal and external auditors.

## EXAMINATION PLANNING

Examiners assigned to review the international activities of the bank should work closely with commercial examiners, especially in those areas in which international and domestic activities have a direct relationship. This cooperation includes the pre-examination analysis of the bank and is intended to determine potential problem areas and provide for adequate staffing.

## COMPUTER SERVICES

During an examination that covers information technology (IT) and electronic data processing (EDP) services, provided either in-house or externally, the examiner should review the contents of the IT and EDP report of examination to determine which sections may be applicable to international operations. An IT-EDP examiner will generally perform the procedures in this section and should be consulted on matters applicable to international operations.

## ASSET AND LIABILITY MANAGEMENT

Asset and liability management (see section 4020.1) and interest-rate risk management (see section 4090.1) sections of the manual are completed by domestic examiners for the entire bank, based, in part, on information prepared by examiners assigned to various international banking activities. Whether applicable segments of these sections will be completed during overseas examinations depends on the type of overseas examination conducted.

## BANK-RELATED ORGANIZATIONS

The domestic examiner assigned to bank-related organizations (see section 4050.1) obtains and circulates lists and information to the international examiner concerning bank-related organizations involved in international activities. Besides determining the legality of the relationships, the international examiner should verify the accuracy and completeness of the information obtained.

## REVIEW OF REGULATORY REPORTS

The domestic examiner assigned to review regulatory reports (see section 4150.1) circulates the bank-prepared regulatory reports applicable to international operations. The international examiner will prepare any necessary comments on the appropriate report format and will discuss those comments with bank management.

## LITIGATION AND OTHER LEGAL MATTERS, EXAMINATION-RELATED SUBSEQUENT EVENTS

The international examiner should request from bank management a list of pending or threatened litigation and subsequent events applicable to international operations of the bank. Comments in the report should be limited to events or transactions that could materially affect the soundness of the bank. (See section 4100.1.)

## MANAGEMENT ASSESSMENT

The overall evaluation of the management of international operations should be made by the examiner assigned to review international operations who is in a position to identify the strengths and weaknesses of the management team. An appraisal of local management should

also be made if on-site examinations of foreign branches and subsidiaries are conducted.

## OVERALL CONCLUSIONS REGARDING CONDITION OF THE BANK

The examiner-in-charge is typically responsible for overall conclusions regarding the condition of the bank. (See section 5020.1.) However, the examiner assigned to review international operations must use judgment in deciding which steps in this section should be omitted. For example, certain examination procedures relating to earnings, liquidity, and ownership apply to the entire bank and not to the international area alone. However, international examiners should assist domestic examiners in developing report comments when international activities have a significant impact on the analysis of these areas.

*Acceptance.* A time draft (bill of exchange or usance draft) drawn by one party and acknowledged by a second party. The drawee, known as the “acceptor,” stamps or writes the word “accepted” on the face of the draft and, above his or her signature, the place and date of payment. Once the draft is accepted, it carries an unconditional obligation on the part of the acceptor to pay the drawer the amount of the draft on the date specified. A *bank acceptance* is a draft drawn on, and accepted by, a bank. A *trade acceptance* is a draft drawn by the seller of goods on the buyer and accepted by the buyer. See also *Banker’s acceptance*.

*Account-account dealing.* Foreign-exchange dealing that involves settlement from bank-to-bank in the due from accounts. No third party (bank) is involved.

*Account party.* The party, usually the buyer, who instructs the bank to open a letter of credit and on whose behalf the bank agrees to make payment.

*Ad valorem.* A term meaning “according to value,” used for assessing customs duties that are fixed as a percentage of the value stated on an invoice.

*Advance.* (1) A drawing or payout of funds representing the disbursement of a loan, including disbursement in stages. (2) In international banking, an extension of credit, usually recurring, in which no instrument (other than a copy of the advice of an advance) is used as evidence of a specified indebtedness, except in special cases. A signed agreement must be on file in the department and state the conditions applicable to payments made to the borrower. This loan category does not include commercial account overdrafts, but an advance may be created to finance payments effected under a commercial letter of credit, to finance payments of collections, or to refinance a maturing loan.

*Advance against documents.* An advance made on the security of the documents covering a shipment.

*Advised letter of credit.* See *Letter of credit—advised*.

*Advised line.* A credit authorization that will be made known to the customer. See also *Guidance line*.

*Affiliate.* With regard to a member bank, any company (including corporate or other forms of a business entity) of which a member bank is a

subsidiary or any other subsidiary of that company.

*After sight.* When a draft bears this name, the time to maturity begins at its presentation or acceptance.

*Agent bank.* The bank that leads and documents a syndicated loan.

*Aggregate limit.* The total volume of unliquidated foreign-exchange contracts allowed to be outstanding at any one time.

*Agreement corporation.* A company chartered or incorporated under state law that, like an Edge Act corporation, is principally engaged in international banking. See also *Edge Act*.

*Allocated transfer-risk reserve (ATRR).* The ATRR is a special reserve established and maintained for specified international assets pursuant to the International Lending Supervision Act of 1983.<sup>1</sup> At least annually, the Federal Reserve and the other federal banking agencies (federal banking agencies) determine jointly—

- which international assets that are subject to transfer risk warrant establishment of an ATRR,
- the amount of the ATRR for the specified assets, and
- whether an ATRR previously established for specified assets may be reduced.

When determining whether an ATRR is required for particular international assets, the federal banking agencies consider if the quality of a banking institution’s assets has been impaired by a protracted inability of public or private obligors in a foreign country to make payments on their external indebtedness, as indicated by factors as to—

- whether such obligors have failed to make full interest payments on external indebtedness, or
- whether such obligors have failed to comply with the terms of any restructured indebtedness, or
- whether a foreign country has failed to comply with any International Monetary Fund (IMF) or other suitable adjustment program, or
- whether no definite prospects exist for the orderly restoration of debt service.

1. See 12 USC 3904(a). See also the Board’s January 9, 2003, approval of a revision to subpart D (on international lending supervision) of Regulation K (12 CFR 211), International Banking Operations (69 *Fed. Reg.* 1158–1161).



Also, when determining the amount of the ATRR, the federal banking agencies consider—

- the length of time the quality of the asset has been impaired,
- what recent actions have been taken to restore debt-service capability,
- the prospects for restored asset quality, and
- any other factors relevant to the quality of the asset.

The initial year's provision for the ATRR will be 10 percent of the principal amount of each specified international asset, or such greater or lesser percentage determined by the federal banking agencies. Additional provisions, if any, in subsequent years will be 15 percent of the principal amount of each specified international asset, or such greater or lesser percentage determined by the federal banking agencies.

The ATRR is established only by a charge to current income. The amounts charged cannot be included in the banking institution's capital or surplus. (For these and other requirements, as well as for certain other accounting procedures for the ATRR, the reporting and disclosure of international assets, and the accounting for fees on international loans, see sections 211.43, 211.44, and 211.45 of Regulation K.) A banking institution does not have to establish an ATRR if it writes down in the period in which the ATRR is required, or has written down in prior periods, the value of the specified international assets in the requisite amount for each such asset.

*Amortizing swap.* A transaction in which the notional value of the agreement declines over time.

*Appreciation.* A rise in the value of a currency relative to the market of another currency.

*Arbitrage.* Simultaneous buying and selling of foreign currencies, securities, or commodities to realize profits from discrepancies between exchange rates prevailing at the same time in different markets, between forward margins for different maturities, or between interest rates prevailing at the same time in different markets or currencies.

*Asian currency unit.* A foreign-exchange trading department of a bank located in Singapore that has received a license from the monetary authority in that country to deal in external currencies.

*Asked price.* The price sought by any prospec-

tive seller of an asset or the price at which a market maker of an asset will sell.

*Assignment.* The transfer in writing by one person to another of title to personal property. In banking, one bank may assign another the right to receive loan principal and interest from a borrower. The assignment of stocks or registered bonds may be effected by filling in the form printed on the reverse of the certificate.

*Association of International Bond Dealers (AIBD).* A private association founded in Zurich, Switzerland, in 1969 to establish uniform issuing and trading procedures in the international bond markets.

*At sight.* A term indicating that a negotiable instrument is payable upon presentation or demand.

*At the money.* A term used to refer to a call or put option whose strike price is equal (or virtually equal) to the current price of the asset on which the option is written.

*Authority to pay.* An advice from a buyer, sent by his or her bank to the seller's bank, authorizing the seller's bank to pay the seller's (exporter's) drafts up to a fixed amount. The seller has no protection against cancellation or modification of the instrument until the issuing bank pays the drafts drawn on it, in which case the seller is no longer liable to its bank. These instruments are usually not confirmed by the seller's American bank.

*Authority to purchase.* Similar to an authority to pay, except that drafts under an authority to purchase are drawn directly on the buyer. The correspondent bank purchases them with or without recourse against the drawer and, as in the case of the authority to pay, they are usually not confirmed by an American bank. This type of transaction is unique to Far Eastern trade.

*Baker Plan.* Proposed in 1985, this initiative encouraged banks, the IMF, and the World Bank to jointly increase lending to less developed countries (LDCs) that were having difficulty servicing their debt, provided the countries undertook prudent measures to increase productive growth.

*Balance of payments.* A term indicating a nation's external cash flow (to other countries, whether positive or negative) for a given period of time, including trade, current financial, and capital inflows and outflows.

*Balance of trade.* The difference between a country's total imports and total exports for a

given period of time. A “favorable” balance of trade exists when exports exceed imports.

**Band.** The maximum range that a currency may fluctuate from its parity with another currency or group of currencies by official agreement.

**Bank for International Settlements (BIS).** Established in 1930 in Basel, Switzerland, the BIS is the oldest functioning international financial organization. It provides a forum for frequent consultation among central bankers on a wide range of issues.

**Banker's acceptance.** A time draft that has been drawn on and accepted by a bank. The bank accepting the time bill becomes primarily liable for payment. See also *Acceptance*.

**Banker's acceptance liability.** The moment the draft is accepted by the bank, a direct liability is recorded in its “Acceptances Executed” account. The contra account on the asset side of the balance sheet is “Customer's Liability on Acceptances.” On the date of maturity of the banker's acceptance, the bank charges the customer's account and retires the acceptance by paying the beneficiary or drawee of the draft. The bank's liability records at this point are liquidated, and the transaction is completed.

**Barter.** The exchange of commodities using merchandise as consideration instead of money. This scheme has been employed in recent years by countries that have blocked currencies.

**Base rate.** A rate used as the basis or foundation for determining the current interest rate to be charged to a borrower, such as the prime rate or London Interbank Offered Rate (LIBOR).

**Basel Capital Accord.** An agreement among the central banks of leading industrialized countries, including those of Western Europe, Canada, the United States, and Japan, to impose common capital requirements on their internationally active banks to take into account bank risk exposure.

**Basis.** The cash or spot price minus the futures price.

**Basis risk.** The risk associated with nonparallel movement of interest rates. Banks face exposure in two situations. The first occurs when an operator uses, for example, a Treasury bill to hedge an interest-rate risk in Eurodollars. The interest rates for T-bills and Eurodollars do not always move exactly parallel to each other. The risk of this lack of parallel movement is basis risk. The second occurs when the period of time for which a financial risk exists is not identical with the period of time for which the

hedge is arranged, for example, when a three-month interest risk in a revolving Eurodollar loan is hedged with a six-month futures contract in Eurodollars. A change in the shape of the yield curve can bring about nonparallel movements in interest rates for the two different maturities.

**Basis swap.** A transaction in which one participant pays a floating rate of interest based on one index, and the other party pays a floating rate of interest based on another interest-rate index.

**Beneficiary.** The person or company in whose favor a letter of credit is opened or a draft is drawn.

**Bid-asked spread.** The difference between a bid and the asked price, for example, the difference between 0.4210 and 0.4215 would be a spread of 0.0005 or 5 points.

**Bid rate.** The price at which the quoting party is prepared to purchase a currency or accept a deposit. If the bid rate is accepted by the party to whom it was quoted, then that party will sell currency or place or lend money at that price. The opposite transaction takes place at the offer rate.

**Bilateral trade.** Commerce between two countries, usually in accordance with specific agreements on amounts of commodities to be traded during a specific period of time. Balances due are remitted directly between the two nations.

**Bill of exchange.** An instrument by which the drawer orders another party (the drawee) to pay a certain sum to a third party (the payee) at a definite future time. The terms “bill of exchange” and “draft” are generally interchangeable.

**Bill of lading.** A receipt issued by a carrier to a shipper for merchandise delivered to the carrier for transportation from one point to another. A bill of lading serves as a receipt for the goods, document of title, and contract between the carrier and the shipper covering the delivery of the merchandise to a certain point or designated person. It is issued in two primary forms: an “order bill of lading,” which provides for the delivery of goods to a named person or to his or her order (designee), but only on proper endorsement and surrender of the bill of lading to the carrier or its agents, and a “straight bill of lading,” which provides for delivery of the goods only to the person designated by the bill of lading.

• **Clean bill of lading.** A bill of lading in which the described merchandise has been received

in “apparent good order and condition” and without qualification.

- *Ocean bill of lading.* A document signed by the captain, agents, or owners of a vessel furnishing written evidence for the conveyance and delivery of merchandise sent by sea. It is both a receipt for merchandise and a contract to deliver it as freight.
- *Order bill of lading.* A bill of lading, usually drawn to the order of the shipper, that can be negotiated like any other negotiable instrument.
- *Order “notify” bill of lading.* A bill of lading usually drawn to the order of the shipper or a bank with the additional clause that the consignee is to be notified upon arrival of the merchandise. However, the mention of the consignee’s name does not confer title to the merchandise.
- *Stale bill of lading.* A bill of lading that has not been presented under a letter of credit to the issuing bank within a reasonable time after its date, thus precluding its arrival at the port of discharge by the time the ship carrying the related shipment has arrived.
- *Straight bill of lading.* A bill of lading drawn directly to the consignee and therefore not negotiable.
- *Through bill of lading.* A bill of lading used when several carriers are used to transport merchandise, for example, from a train to a vessel or vice versa.
- *Unclean bill of lading.* A bill of lading across the face of which exceptions to the receipt of goods “in apparent good order” are noted. Examples of exceptions include burst bales, rusted goods, and smashed cases.

*Black market.* A private market that operates in contravention of government restrictions.

*Blocked account.* An account from which payments, transfers, withdrawals, or other dealings may not be made without Office of Foreign Asset Control (OFAC) or U.S. Treasury Department approval. Although the bank is prohibited from releasing funds from these accounts, deposits may be accepted. Banks are subject to significant fines for releasing funds from blocked accounts. See also *Office of Foreign Asset Control, Specially designated nationals.*

*Blocked currency.* A currency that is prohibited by law from being converted into another foreign currency.

*Book-entry form.* The method by which marketable securities are issued with the buyer receiving only a receipt rather than an engraved

certificate, which indicates that the purchase is recorded on the issuer’s books or recorded in another approved location.

*Brady Plan.* Proposed in 1989 and named after then U.S. Treasury Secretary Nicholas Brady, the Brady Plan sought to reduce the debt-service requirements of various developing countries and to provide new loans (Brady bonds) to service existing obligations.

*Break-even exchange rate.* The particular spot exchange rate that must prevail at the maturity of a deposit or debt in a foreign currency (which has not been covered in the forward market) so that there will be no advantage to any party from interest-rate differentials.

*Bulldog bonds.* British pound sterling-denominated foreign bonds issued in London.

*Bullion.* Unminted precious metals (gold, silver) of standard or stipulated fineness in the form of bars, ingots, or nuggets. The value of gold bullion, usually in bars, used in the settlement of international balances is determined by weight and degree of fineness.

*Buyer’s option contract.* A contract in which the buyer has the right to settle a forward contract at any time within a specified period. See also *Option contracts.*

*Buying rates.* Rates at which foreign-exchange dealers will buy a foreign currency from other dealers in the market and at which potential sellers are able to sell foreign exchange to those dealers.

*C & I loans.* Commercial and industrial loans.

*Cable.* A message sent and delivered by an international record carrier via satellite or cable connections to a foreign country. “Cable” as used in the international sections also includes messages transmitted by bank telex. The terms “cable” and “telex” are generally used interchangeably.

*Call money.* Funds placed with a financial institution without a fixed maturity date. The money can be “called” (withdrawn) at any time by telephone. “Same day” call money means the call must (usually) be made before 10:00 a.m. In addition, “24-hour,” “48-hour,” and “7-day” call money means the money must be called one, two, or seven calendar days before the actual payment date. Although these are the most common varieties of call money, two parties can agree on different dates.

*Call option.* A contract giving the purchaser the right, but not the obligation, to buy an asset at a stated price on or before a stated date.

*Capital controls.* Governmental restrictions

on the acquisition of foreign assets or foreign liabilities by domestic citizens or restrictions on the acquisition of domestic assets or domestic liabilities by foreign citizens.

*Cedel.* Formerly one of the two main clearing systems in the Eurobond market, Cedel, based in Luxembourg, began operations in 1971. Cedel ceased to exist as an independent entity as part of a merger with Clearstream International clearinghouse in 2000. The merger was completed in 2002.

*Central bank intervention.* Direct action by a central bank to increase or decrease the supply of currency to stabilize prices in the spot or forward market or to move them in a desired direction. On occasion, the announcement of an intention to intervene might achieve the desired results.

*Certificate of inspection.* A document often required for shipment of perishable goods in which certification is made as to the good condition of the merchandise immediately before shipment.

*Certificate of manufacture.* A statement, sometimes notarized, by a producer who is usually also the seller of merchandise that manufacture has been completed and that goods are at the disposal of the buyer.

*Certificate of origin.* A document issued by the exporter certifying the place of origin of the merchandise to be exported. The information contained in this document is needed primarily to comply with tariff laws that may extend more favorable treatment to products of certain countries.

*Chain.* A method of calculating cross rates. For example, if a foreign-exchange trader knows the exchange rate for Japanese yen against U.S. dollars and for Swiss francs against U.S. dollars, the “chain” makes possible a calculation of the cross rates for Japanese yen against Swiss francs.

*Charges forward.* A banking term used when foreign and domestic bank commission charges, interest (if any), and government taxes in connection with the collection of a draft are for account of the drawee.

*Charges here.* A banking term used when foreign and domestic bank commission charges, interest (if any), and government taxes in connection with the collection of a draft are for account of the drawer.

*Charter party.* A contract, expressed in writing on a special form, between the owner of a vessel and the one (the charterer) desiring to employ the vessel, setting forth the terms of the arrangement, such as freight rate and ports

involved in the trip contemplated.

*Chicago Board of Trade (CBT).* A futures exchange that merged with the Chicago Mercantile Exchange in 2007 and ceased to exist as an independent entity.

*Chicago Board Options Exchange (CBOE).* An options exchange in which European foreign-currency options on spot exchange are traded.

*Chicago Mercantile Exchange (CME).* A futures exchange.

*Clean collection.* A collection in which a draft or other demand for payment is presented without additional attached documentation.

*Clean draft.* A sight or time draft to which no other documents, such as shipping documents, bills of lading, or insurance certificates, are attached. This is to be distinguished from a documentary draft. See also *Documentary draft*.

*Clean risk at liquidation.* A type of credit risk that occurs when exchange contracts mature. There may be a brief interval (usually no more than a few hours) during which one of the parties to the contract has fulfilled its obligations, but the other party has not. During this period, the first party is subject to a 100 percent credit risk, on the chance that, in the interval, an event may prevent the second party from fulfilling its obligations under the contract.

*Clearing corporation.* A clearinghouse that exists as an independent corporation rather than as a subdivision of an exchange.

*Clearinghouse.* A subdivision of an exchange or an independent corporation through which all trades must be confirmed, matched, and settled daily until offset.

*Clearinghouse funds.* Funds used in settlement of a transaction that are available for use or that become good funds after one business day.

*Clearing House Interbank Payments System (CHIPS).* A computerized telecommunications network provided by the New York Clearing House Association (NYCHA), which serves as an automated clearinghouse for interbank funds transfers.

*Closing a commitment.* Allowing a covered foreign-exchange position to expire on maturity or reversing it before maturity by a swap operation.

*Closing a position.* Covering open long or short positions by means of a spot operation and/or outright forward operation.

*Comanager.* A bank ranking just below that of lead manager in a syndicated Eurocredit or an international bond issue. The status of comanager usually indicates a larger share in the

loan or a larger bond allotment, and a larger share in the fees, than banks of lower rank. Comanagers may also assist the lead managers in assessing the market or determining terms of the loan.

*Combined transport document.* A through bill of lading that applies to more than one mode of transport.

*Commercial paper.* A short-term, unsecured debt instrument issued by a corporation and sold at a discount from its maturity value.

*Commercial transaction.* A transaction between a dealing bank and a nonbanking (commercial) party.

*Commodities Futures Trading Commission (CFTC).* A U.S. regulatory body that regulates exchange-based futures trading in the United States.

*Commodity Credit Corporation (CCC).* An instrument of the federal government whose principal purpose is to provide the necessary financial services to carry forward the public price-support activities, including government lending, purchasing, selling, storing, transporting, and subsidizing certain agricultural commodities.

*Common carrier.* An individual, partnership, or corporation, such as a shipping line, railroad, or airline, that undertakes for hire to transport persons or commodities from place to place. Governed by special laws, common carriers must accept all business offered them under their regulations.

*Compromises.* Occasions when both parties agree to alter the terms of an existing foreign-exchange contract. These alterations should be approved by an impartial bank officer and the operations personnel must be advised of each compromise to avoid settlement in accordance with the original terms.

*Confirmation.* The written communication to the counterparty in a foreign exchange, interbank deposit, or other money market transaction that recites all the relevant details agreed upon by phone or telex.

*Confirmed letter of credit.* See *Letter of credit*.

*Consignment.* The physical transfer of goods from a seller (consignor), with whom the title remains, to another legal entity (consignee), who acts as a selling agent, selling the goods and remitting the net proceeds to the consignor.

*Consular documents.* Bills of lading, certificates of origin, or special forms of invoice that carry the official signature of the consul of the country of destination.

*Consular invoice.* A detailed statement on the character of goods shipped, which is duly certified by the consul at the port of shipment. Required by certain countries, including the United States, its principal function is to accurately record the types of goods and their quantity, grade, and value for import duty and general statistical purposes.

*Contract limit.* A maximum limit on the total gross notional principal amount of outstanding contracts booked with one customer.

*Contract risk (counterparty risk).* Risk that the counterparty will default before settlement.

*Convertibility.* Freedom to exchange a currency, under certain circumstances, without government restrictions or controls.

*Correspondent bank.* A bank located in one geographic area that accepts deposits from a bank in another region and provides services on behalf of this other bank. Internationally, many banks maintain one account with a correspondent bank in each major country to be able to make payments in all major currencies. Correspondent banks are usually established on a reciprocal basis.

*Cost, insurance, and freight (C.I.F.).* A price quotation under which the seller defrays all expenses involved in the delivery of goods.

*Counterpart funds.* Local currencies deposited in a special account by recipient governments that represent grant aid extended by another government. Those funds, while remaining the property of the recipient government, can generally be used only by agreement of the donor government.

*Country exposure.* A measurement of the volume of assets and off-balance-sheet items considered to be subject to the risk of a given country. This measurement is based, in part, on identifying the country of domicile of the entity ultimately responsible for the credit risk of a particular transaction.

*Country limit.* The amount of money that a bank has established as the maximum it is willing to lend borrowers in a given country regardless of the type of borrower or the currencies involved.

*Country risk.* Refers to the spectrum of risks arising from the economic, social, and political environment of a given foreign country, which could have favorable or adverse consequences for foreigners' debt and/or equity investments in that country.

*Cover.* The execution of an offsetting foreign-

exchange trade to close or eliminate an open exposure.

*Covered interest arbitrage.* The process of taking advantage of a disparity between the net accessible interest differential between two currencies and the forward exchange premium or discount on the two currencies against each other.

*Crawling peg system.* An exchange-rate system in which the exchange rate is adjusted every few weeks, usually to reflect prevailing inflation rates.

*Credit risk.* The possibility that the buyer or seller of foreign exchange or some other traded instrument may be unable to meet his or her obligation on maturity.

*Credit swap.* A link transaction wherein one party places a deposit in one currency (probably dollars) with a foreign bank during the period that the foreign bank lends another currency to a third party. The deposit serves as an inducement for the transaction, and its value is considered in pricing the loan.

*Cross-border exposure.* The risk that arises when an office of a bank, regardless of its location or currency, extends credit to a borrower that is located outside the booking unit's national border.

*Cross-currency risk.* The risk associated with maintaining exchange positions in two foreign currencies as the result of one transaction. For example, if a U.S. operator borrows Swiss francs at 5 percent and invests the proceeds in British pounds at 12 percent, the cross-currency risk is the chance that the pounds will depreciate in value against the Swiss francs to such an extent that there will be a loss on the transaction in spite of the favorable interest-rate differential.

*Cross-default.* A term used to describe a clause in a syndicated loan or bond contract that gives the lender the right to accelerate repayment of the loan if the borrower defaults on another loan.

*Cross-hedging.* The hedging of an asset with a futures contract of a different asset.

*Cross rate.* The ratio between the exchange rates of two foreign currencies in terms of a third currency.

*Currency futures and options contracts.* An agreement that allows businesses or individuals acquiring or selling foreign currencies to protect themselves against future fluctuations in currency prices by shifting currency risk to someone willing to bear that risk.

*Currency liquidity.* In a multicurrency investment portfolio, the liquidity of a given foreign

currency has to be viewed in terms of exchange liquidity and instrument liquidity. Exchange liquidity depends on the ease with which a currency can be converted into and out of another major currency. Instrument liquidity depends on the ease with which a negotiable instrument denominated in that currency can be purchased and sold without noticeably affecting the market rate for that instrument.

*Currency swap.* A contractual obligation entered into by two parties to deliver a sum of money in one currency against a sum of money in another currency at stated intervals (or a stated interval) or according to negotiated terms. See *Swap*.

*Current account.* Those items in the balance of payments involving imports and exports of goods and services as well as unilateral transfers.

*Customs union.* An agreement between two or more countries in which they arrange to abolish tariffs and other import restrictions on each other's goods and to establish a common tariff for the imports of all other countries.

*Date draft.* A draft drawn to mature on a fixed date, regardless of its acceptance.

*Daylight limit.* The maximum net foreign-exchange position that a bank will allow during business hours.

*Dealer (or trader).* A person who executes foreign-exchange, interbank deposit, or other money market trades for a dealing bank.

*Debt for equity swaps.* Debt (usually LDC government debt) that is discounted and exchanged for equity in local businesses (often newly privatized).

*Debt swaps.* The exchange of LDC loans based on the prices quoted in the secondary market. Swaps are often used to decrease exposure to certain countries.

*Default risk.* The risk to the holder of debt securities that a borrower will not meet all promised payments at the times agreed upon.

*Del credere agent.* A sales agent who, for a certain percentage above his or her sales commission, guarantees payment to the person for whom he or she is selling on shipments made to the seller's customers.

*Delivery.* The offset of an obligation to buy or sell an asset by an actual transfer of title to the asset at a prearranged price. In the futures market, the transfer or receipt of a cash instrument against a short or long futures contract.

*Delivery order.* An order addressed to the holder of goods and issued by anyone who has



authority to do so, that is, by one who has the legal right to order delivery of merchandise. A delivery order is not considered a good titled document.

*Delivery risk.* The possibility that a seller of foreign exchange, having collected the payment in local currency, may fail to deliver the exchange in the foreign center where it was sold. Also called settlement risk.

*Delta of an option.* The rate of change of the value of an option with respect to the price of the underlying asset, reference rate, or index evaluated at the current market price of that underlier.

*Demand draft.* A draft that is payable immediately upon presentation to the drawee. This type of draft is also termed a “sight” or “presentation” draft.

*Deposit dealer.* A term used in the United States for bank personnel responsible for lending and borrowing funds in the interbank market.

*Deposit trader.* A term used in Europe for bank personnel responsible for lending and borrowing funds in the interbank market.

*Depreciation.* A drop in the value of a currency relative to the value of another currency.

*Depth of the market.* The amount of currency that can be traded in the market at a given time without causing a price fluctuation. Thin markets are usually characterized by wide spreads and substantial price fluctuations during a short period of time. Strong markets tend to be characterized by relatively narrow spreads of stable prices.

*Derivative instrument.* An instrument that is based on or derived from the value of an underlying asset, reference rate, or index. For example, interest-rate futures are based on various types of securities trading in the cash market. Some interest-rate options are derived from interest-rate futures.

*Devaluation.* An official act wherein the official parity of a country’s currency is adjusted downward to the dollar, gold, Special Drawing Rights (SDRs), or another currency. After a devaluation, there are more devalued currency units relative to the dollar, gold, SDRs, or other currency. See also *Revaluation*.

*Development bank.* A lending agency that provides assistance to encourage economic development.

*Direct quote.* The method of quoting fixed units of foreign exchange in variable numbers of the local currency unit. Also called a “fixed” or “certain” quotation.

*Dirty float (or Managed float).* A floating

exchange-rate system in which some government intervention still takes place. A government may announce that it will let its currency float, that is, it will let the currency’s value be determined by the forces of supply and demand in the market. The government, however, may secretly allow its central bank to intervene in the exchange market to avoid too much appreciation or depreciation of the currency.

*Discount.*

- *Lending*—To subtract from a loan, when it is first made, the amount of interest that will be due when it is repaid.
- *Foreign exchange*—The amount by which the forward exchange rate of one currency against another currency is less than the spot exchange rate between the two currencies.
- *Financial*—A deduction from the face value of commercial paper, such as bills of exchange and acceptances, in consideration of cash the seller has received before the maturity date. The rates of discount vary according to the state of the given money market, the financial standing of the persons involved, and other circumstances surrounding the transaction.
- *Commercial*—An allowance from the quoted price of goods, usually made by the deduction of a certain percentage from the invoice price.

*Discount rate.* Most commonly the rate at which a Federal Reserve Bank (or, in many instances, foreign central banks) is prepared to lend to financial institutions against eligible collateral.

*Dishonor.* Refusal on the part of the drawee to accept a draft or to pay it when due.

*Divergence indicator system.* One aspect of the European Monetary System that measures the departure of a country’s economic policies from the European Union’s “average.” The measure of divergence is based exclusively on the movement of a country’s exchange rate with respect to the euro.

*Dock receipt.* A receipt issued by an ocean carrier or its agent for merchandise delivered at its dock or warehouse that is awaiting shipment.

*Documentary collection.* A collection in which a draft is accompanied by shipping or other documents.

*Documentary credit.* A commercial letter of credit providing for payment by a bank to the named beneficiary, who is usually the seller of merchandise, against delivery of documents specified in the credit.

*Documentary draft.* A draft to which docu-

ments are attached, that is delivered to the drawee upon acceptance or payment of the draft and that ordinarily controls title to the merchandise.

*Documents.* The shipping and other papers customarily attached to foreign drafts, consisting of ocean bills of lading, marine insurance certificates, and commercial invoices. Certificates of origin and consular invoices may also be required.

*Documents against acceptance (D/A).* Instructions given by an exporter to a bank that the documents attached to a draft for collection are deliverable to the drawee only against his or her acceptance of the draft.

*Documents against payment (D/P).* Instructions given by an exporter to his or her bank that the documents attached to a draft for collection are deliverable to the drawee only against his or her payment of the draft.

*Domestic bond.* A domestic debt security sold by an issuer in its own country and denominated in that country's currency.

*Domicile.* The place where a draft or acceptance is made payable.

*Draft.* An order in writing signed by one party (the drawer) requesting a second party (the drawee) to make payment at a determinable future time to a third party (the payee). It may be accompanied by a bill of lading, which the bank will surrender to the buyer upon payment of the draft. The buyer may then claim the goods at the office of the carrier who transported them to the buyer's place of business. See also *Sight draft* or *Time draft*.

*Dragon bond.* A bond issued by a foreign borrower in an Asian or Pacific country (excluding Japan—see *Samurai bond*).

*Drawee.* The addressee of a draft, that is, the person on whom the draft is drawn.

*Drawer.* The issuer or signer of a draft.

*Duration.* A time-weighted present-value measure of the cash flow of a loan or security that takes into account the amount and timing of all promised interest and principal payments associated with that loan or security.

*Duty.* (1) Ad valorem duty (according to the value) is an assessment at a certain percentage rate on the actual value of an article. (2) Specific duty is an assessment on the weight or quantity of an article without reference to its monetary value or market price. (3) Drawback is a recovery in whole or in part of duty paid on imported merchandise at the time of reexportation, whether in the same or different form.

*Edge Act.* Incorporated as section 25A of the Federal Reserve Act, this act authorizes the Board of Governors to charter corporations (Edge corporations) for the purpose of engaging in international or foreign banking or in other international operations.

*Eligible acceptance.* A banker's acceptance that meets Federal Reserve requirements related to its financing purpose and term.

*Eligible value date.* A normal business day on which a payment to settle a money market transaction can be made. An eligible value date for a foreign-exchange transaction must be a business day in the home countries of both of the currencies involved.

*Engineered swap transaction.* A spot transaction and an offsetting forward transaction in which each of the two transactions is carried out with a different party.

*Eurobank.* A bank that regularly accepts foreign currency-denominated deposits and makes foreign-currency loans.

*Eurobonds.* Long-term debt securities denominated in a currency other than that of the country or countries where most or all of the security is sold.

*Euroclear.* Euroclear Clearance System Limited is one of two main clearing systems in the Eurobond market. Euroclear, which began operations in December 1968, is located in Brussels and managed by Euroclear Bank SA. See also *Cedel*.

*Eurocurrency.* The nonresident ownership of one of the major western European currencies. Eurocurrencies, similar to Eurodollars, are frequently available for borrowing in the London Interbank Market.

*Eurocurrency market.* The money market for borrowing-and-lending currencies that are held in the form of deposits in banks located outside the countries in which those currencies are issued as legal tender.

*Eurodollars.* Dollar deposit claims on U.S. banks that are deposited in banks located outside the United States, including foreign branches of U.S. banks. These claims, in turn, may be redeposited with banks or lent to companies, individuals, or governments outside the United States.

*Eurodollar deposit rate.* The interest rate at which a quoting bank is willing to take wholesale Eurodollar funds with a particular maturity from other than an interbank participant. The rate is usually one-eighth to one-sixteenth of one percent lower than LIBOR.



*European Currency Unit (ECU).* A portfolio currency used in the European Monetary System as a community “average” exchange rate. It was also used in the private market as a means of payment and as a currency of denomination for lending, borrowing, and trade. On January 1, 1999, the euro replaced the ECU.

*European Monetary System (EMS).* An arrangement introduced in March 1979 for economic and monetary cooperation among the members of the European Union. The ultimate aim of the EMS is a single European currency and the establishment of a European central bank.

*European Union (EU).* Formerly the European Community, an economic association of European countries founded by the Treaty of Rome in 1957. The goals of the EU are the removal of trade barriers among countries, the formation of a common commercial policy toward non-EU countries, and the removal of barriers restricting competition and the free mobility of factors of production. Members include Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom.

*Exchange contracts.* Documents issued by foreign-exchange dealers, banks dealing in foreign exchange, and foreign-exchange brokers confirming foreign-exchange transactions.

*Exchange control or restrictions.* Limits on free dealings in foreign exchange or of free transfers of funds into other currencies and other countries.

*Exchange control risk.* The possibility of defaults on obligations by imposing or reinforcing exchange control.

*Exchange-rate differential.* The difference between two exchange rates in a swap transaction.

*Exchange rates.* The price of one currency in terms of another. See also *Spot exchange*, *Buying rates*, *Fixed rate of exchange*, *Floating rate*, and *Interbank rate of exchange*.

*Exchange reserves.* The total amount of freely convertible foreign currencies held by a country’s central bank.

*Exchange risk.* The possibility of a loss on an open position as a result of an appreciation or depreciation of the exchange.

*Exercise.* The use of the right given by an option: purchase (if a call) or sale (if a put) of an

asset at the strike price stated in the option contract.

*Exit bonds.* Low-interest government bonds issued in LDCs that are equivalent to a portion of the country’s existing bank debt. Designed to facilitate debt management.

*Expiration date.* The last day on which an option may be exercised.

*Export credit insurance.* A system to insure the collection of credits extended by exporters against various contingencies. In some countries, only noncommercial risks can be insured.

*Export declaration.* A document required by the U.S. government for shipments abroad and used to maintain statistics on our exports.

*Export-Import Bank of the United States (Eximbank).* An institution that provides intermediate and long-term nonrecourse financing for U.S. exports when these facilities are not available from commercial banks. All of the Eximbank’s shares are held by the U.S. Treasury.

*Export trading company (ETC).* A company designed to facilitate U.S. exports. An ETC may be an affiliate of a bank holding company.

*Fail.* Nonperformance of an obligation on the specified day, for example, failure to make prompt settlement for either side of a foreign-exchange contract, usually due to a clerical or trader error. A fail usually leads to an interest adjustment for an overdraft in the paying or receiving bank.

*F.A.S.* See *Free alongside ship*.

*Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).* This act had various aims, including the least-cost resolution of troubled insured depository institutions, improvement of bank supervision and examinations, and provision of additional resources to the Bank Insurance Fund.

*Federal funds.* Deposits held by commercial banks at a Federal Reserve Bank. Since reserve requirements of commercial banks are satisfied by federal funds, banks with deposits in excess of required reserves will lend the excess deposits to banks with a reserve shortage at a market-determined interest rate, called the federal funds rate.

*Federal Reserve System.* The central bank of the United States, created by the Federal Reserve Act of 1913, consisting of the Board of Governors in Washington, D.C., and 12 regional Federal Reserve Banks. The Federal Reserve controls the country’s monetary base and has the power to set reserve requirements, conduct open-market operations, and lend directly to banks.

*Fedwire.* The large-value payment mechanism owned and operated by the Federal Reserve System. Fedwire provides depository institutions with real-time settlement in the central bank of funds transfers and book-entry securities transfers made for their own account or on behalf of their customers.

*Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).* The purpose of this act was to reform, recapitalize, and consolidate the federal deposit insurance system and to enhance the regulatory and enforcement powers of federal financial institutions' regulatory agencies.

*Fixed exchange-rate system.* A system in which the exchange rate of a country's currency is tied to one major currency, such as the U.S. dollar.

*Fixed rate of exchange.* A rate of exchange set by a foreign government relative to the dollar, gold, another currency, or perhaps Special Drawing Rights. It remains in effect as long as that government is willing or able to buy and sell at the set rates.

*Fixed-rate payer.* A position applicable to a rate swap, in which the fixed payer pays the fixed rate and receives the floating rate.

*Flexible rate of exchange.* A rate of exchange subject to relatively frequent changes. It is determined by market forces but subject to various floors or ceilings relative to the dollar, gold, Special Drawing Rights, or another currency when the rate fluctuates beyond certain parameters.

*Floating exchange-rate system.* A system in which the values of the currencies of various countries relative to each other are established by supply and demand forces in the market without government intervention.

*Floating rate.* A rate of exchange that is determined completely by market forces, with no floor or ceiling vis-a-vis the dollar, gold, Special Drawing Rights, or another currency.

*Floating-rate notes.* Bonds that pay interest at an agreed margin above a market reference rate. The interest rate varies according to variations in the market reference rate.

*Floating-rate payer.* A position applicable to a rate swap, in which the floating payer pays the floating rate and receives the fixed rate.

*F.O.B.* See *Free on board (destination or vessel)*.

*Foreign Bank Supervision Enhancement Act (FBSEA).* Part of the FDIC Improvement Act of 1991, FBSEA expanded the supervisory author-

ity of the Federal Reserve over the U.S. operations of foreign banks.

*Foreign bonds.* Bonds issued by nonresidents but underwritten primarily by banks registered in the country where the issue is made.

*Foreign Credit Insurance Association (FCIA).* An insurance company established under the auspices of Eximbank. Insurers trade credits granted by U.S. suppliers of products to purchasers abroad who qualify as normal risks. The insurance protects the exporter, up to an agreed percentage, against any nonpayment resulting from commercial or political risks, or both. Eximbank provides reinsurance for the entire portion of the commercial credit risk and is the sole insurer of the political risk.

*Foreign currency.* The currency of any foreign country that is the authorized medium of circulation and the basis for recordkeeping in that country. Foreign currency is traded by banks either by the actual handling of currency and checks or by the establishment of balances in foreign currencies with banks in those countries.

*Foreign deposits.* Those deposits that are payable at a financial institution outside the jurisdiction of the U.S. government and in the currency of the country in which the depository is located. See also *Nostro account*.

*Foreign draft.* An official bank order drawn on a foreign correspondent bank to pay on demand to a designated payee a specific sum of foreign money or U.S. dollars at the drawee's buying rate.

*Foreign exchange.* The trading or exchange of a foreign currency in relation to another currency.

*Foreign-exchange futures contracts.* Standardized contracts traded on an organized futures exchange and settled through the clearinghouse of the exchange. Each contract defines the currencies, contract amounts, and delivery dates for its own contracts.

*Foreign-exchange market.* Communications between dealers and brokers to transact wholesale business in foreign exchange and Eurocurrencies.

*Foreign-exchange rationing.* A government requirement that all holders of bills of exchange relinquish them at a stipulated rate.

*Foreign-exchange reserves (official).* The reserves maintained by a central bank, which usually include gold and easily traded currencies of major industrial nations.

*Foreign-exchange risk.* The risk associated

with exposure to fluctuation in spot exchange rates.

*Foreign Investment Advisory Service (FIAS).* Established in 1986, FIAS counsels developing countries on attracting foreign capital. FIAS operates under the aegis of the World Bank and its affiliates, the International Finance Corporation and the Multilateral Investment Guarantee Agency.

*Foreign trade zone.* An area where goods may be received and stored without entering a country's customs jurisdiction and without paying duty. Sometimes called a "free trade zone."

*Forward book.* The aggregate of all forward contracts for a given currency or all currencies.

*Forward contract.* A contract that obligates one party to sell and another to buy a specific asset for a specified price at a designated time.

*Forward discount ("at a forward discount").* A phrase used to describe a currency whose forward price is cheaper than its spot price.

*Forward exchange.* Foreign currency traded for settlement beyond two working or business days from today.

*Forward exchange position.* The long or short position that a dealer may have in the forward market, as compared to spot dealing.

*Forward exchange risk.* The possibility of a loss on a covered position as a result of a change in the swap margin.

*Forward-forward dealing.* The simultaneous purchase and sale of a currency for different forward dates.

*Forward premium ("at a forward premium").* A phrase used to describe a currency whose forward price is more expensive than its spot price.

*Forward purchase.* An outright purchase of a forward contract.

*Forward rates.* The actual rates at which foreign exchange for future delivery are quoted, bought, and sold.

*Forward swap.* A transaction in which the initial fixed- and floating-rate payments are deferred until a future period of time.

*Forward transaction date.* Value dates that are more than two business days following the trade date. Regular forward dates are 30, 60, and 90 days from the trade date.

*Free alongside ship (F.A.S.).* A term for a price quotation under which the seller delivers merchandise free of charge to the steamer's side and pays lighterage expenses up to that destination, if necessary.

*Free on board (F.O.B.) (destination).* A term

for a price quotation under which the seller undertakes at his or her risk and expense to load the goods on a carrier at a specified location. Expenses subsequent thereto are for account of the buyer.

*Free on board (F.O.B.) (vessel).* A term for a price quotation under which the seller delivers the goods at his or her expense on board the steamer at the location named. Subsequent risks and expenses are for account of the buyer.

*Free port.* A foreign trade zone, open to all traders on equal terms, where merchandise may be stored duty-free pending its reexport or sale within that country.

*Free trade area.* An arrangement between two or more countries for free trade among themselves, although each nation maintains its own independent tariffs toward nonmember nations. It should not be confused with "free trade zone," which is synonymous with "foreign trade zone."

*Fungible securities.* Securities that are not individually designated by serial number as belonging to a particular owner. Instead, a clearing system or depository institution credits owners with a given number of a particular bond issue (or other security issue). The owner may have title to 50 bonds, but not to 50 specific bonds with designated serial numbers.

*Futures commission merchant (FCM).* A firm that is registered with the CFTC and legally authorized to solicit or accept orders from the public for the purchase or sale of futures contracts. Acts as an intermediary between a public customer and a floor broker.

*Futures contract.* An exchange-traded contract in which one party agrees to buy a security and another agrees to sell a security in the future. If held until maturity, the futures contract may involve accepting (if long) or delivering (if short) the asset on which the futures price is based.

*Futures market.* A market in which contracts are traded for future delivery of commodities, currencies, and financial instruments. The purchase or sale of a futures contract requires that a deposit, called margin, be maintained with a broker. The market is designed in such a way that it is easy to get out of a contract or cancel. The vast majority of participants, the buyers and sellers of futures contracts, do not intend to take delivery or deliver what they bought or sold. Futures contracts are used as an investment vehicle and as a vehicle for hedging positions.

*G-10 countries.* The informal term for the

Group of 10 countries, which consists of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, the United Kingdom, and the United States. Switzerland joined in 1984, but the name remains as is.

*Gap.* The period, in foreign-exchange transactions, between the maturities for purchases and those for sales of each foreign currency (exchange gap). In money market transactions, the period between the maturities of placements (loans) and the maturities of borrowing (deposits) of each currency (money market gap). The former occurs when a currency is purchased against one currency and sold against another, each time for different maturities. The money market gap is created by lending an amount of a certain currency for a longer or shorter period than that for which the same currency is borrowed.

*Global bond.* A temporary debt certificate issued by a Eurobond borrower, representing the borrower's total indebtedness. The global bond will subsequently be replaced by individual bearer bonds.

*Global line.* A bank-established aggregate limit that sets the maximum exposure the bank is willing to have to any one customer on a worldwide basis. See also *Multicurrency line*.

*Gray market.* A forward market for newly issued bonds that takes the form of forward contracting between market participants during the period between the announcement day of a new issue and the day final terms of the bond issue are signed. Bonds are traded at prices stated at a discount of premium to the issue price.

*Group of Eight (G-8).* A group of industrialized countries comprising Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States.

*Guidance line.* An authorization, unknown to the customer, for a line of credit. If communicated to the customer, the guidance line becomes an advised line of credit commitment.

*Hard currency.* The term "hard currency" is a carryover from the days when sound currency was freely convertible into "hard" metal, that is, gold. It is used today to describe a currency that is sufficiently sound so that it is generally accepted internationally at face value.

*Hedging.* A transaction used by dealers in foreign exchange, commodities, or securities, as well as manufacturers and other producers, to protect against severe fluctuations in exchange rates and prices. A current sale or purchase is offset by contracting to purchase or sell at a

specified future date. The object is to defer a profit or loss on the current purchase or sale by realizing a profit or loss on a future purchase or sale. The hedge contract may run for a period that coincides with the expected liquidation of the asset or it may merely last for one, three, six, or twelve months to offset the exchange risk for an asset that is expected to be held for a long term, in which case the choice of the term of the hedge is a matter of relative cost and judgment. Also referred to as "covering."

*Host currency.* See *Local currency*.

*Hot money.* Funds temporarily transferred to a financial center and subject to withdrawal at any moment.

*ICERC.* See *Interagency Country Exposure Review Committee*.

*Impact loan.* A loan specifically designated by a government as important for the development of the country. It usually involves production for export. The term is most often used in regard to Japanese loans.

*Implied forward rate.* The rate of interest at which a borrowing or a lending transaction of a shorter maturity may be rolled over to yield an equivalent interest rate with a borrowing or a lending transaction of longer maturity.

*Indirect quote.* Quotation of a fixed unit of the local currency in variable units of foreign currencies.

*Ineligible acceptance.* An acceptance that does not meet the Federal Reserve eligibility requirements for use at the discount window.

*In the money.* A term used to refer to a call option whose strike price is below or a put option whose strike price is above the current price of the asset on which the option is written.

*Initial margin.* The minimum deposit a futures exchange requires from customers for any futures contract in which a customer has a net long or short position.

*Interagency Country Exposure Review Committee (ICERC).* A nine-member joint committee of three federal regulatory agencies established to administer the country risk supervision program. ICERC centralizes decision making for determinations about the creditworthiness of individual countries.

*Interbank offered rate (IBOR).* The rate at which banks will lend to other banks for a particular currency at a particular location.

*Interest arbitrage.* Involves the movement of short-term funds from one currency to another for the purpose of investing idle funds at a higher yield. However, the real yield advantage

in this situation is not merely the difference in interest rates between the two investment choices, but rather the difference in subtracting the cost of transferring funds into the desired currency and back again from the interest differential. There are four types of interest arbitrage: (1) covered interest arbitrage (transfer of short-term funds into a foreign currency for the sake of a higher yield, with the exchange risk covered), (2) inward interest arbitrage (transfer of short-term funds into local currency for a higher yield), (3) outward interest arbitrage (transfer of short-term funds into a foreign currency for a higher yield), and (4) uncovered interest arbitrage (transfer of short-term funds into a foreign currency for a higher yield, without covering the exchange risk).

*Interest negative.* The commission charged on foreign deposits on which no interest is allowed.

*Interest parities.* Differences at a given time between interest rates charged in two financial centers on short-term credits, investments, or time deposits of identical maturities.

*Interest rate.* The amount (generally expressed as a per annum percentage) of money charged for allowing another party the use of one's money.

*Interest-rate cap.* A transaction whereby a bank pays a fee up-front and will later receive payments if a designated interest rate exceeds a minimum threshold established in the contract. If during the contract, interest rates do not exceed the threshold, the bank loses the initial fee paid. By contrast, if interest rates exceed the threshold, a bank will receive progressively higher payments to offset higher interest expense. The payment received represents the difference between the designated rate and the threshold.

*Interest-rate collar.* The collar combines an interest-rate cap and a floor. A bank buys a cap and pays a fee, which protects the institution should interest rates exceed a stated threshold. The bank simultaneously sells a floor and receives a fee to offset the cost of the cap. The collar establishes a band of interest rates for liabilities—rates cannot exceed the cap's ceiling or the floor's minimum.

*Interest-rate differential.* The difference between the interest rates on two different currencies. Also the swap rate between two currencies expressed as a per annum percentage premium or discount.

*Interest-rate floor.* The floor obligates a seller to pay funds to the buyer if a specified interest

rate falls below a strike rate.

*Interest-rate futures.* Interest-rate futures contracts offer a vehicle through which banks can shift interest-rate risk to the market for financial futures. Interest-rate futures are analogous to futures contracts on commodities. See also *Futures market*.

*Interest-rate swap.* A contractual obligation entered into by two parties to deliver a fixed sum of money against a variable sum of money at periodic intervals. It typically involves an exchange of payments on fixed- and floating-rate debt. If the sums involved are in different currencies, the swap is simultaneously an interest-rate swap and a currency swap.

*International Banking Act of 1978 (IBA).* The principal legislation pertaining to the activities of foreign banks in the United States. It established a policy of national treatment of foreign banks with regard to their operations in the United States.

*International banking facility (IBF).* A set of asset and liability accounts segregated on the books and records of a depository institution, U.S. branch or agency of a foreign bank, or an Edge Act or agreement corporation. IBF activities are essentially limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institutions establishing the IBF. IBFs are not required to maintain reserves against their time deposits or loans. IBFs may receive certain tax advantages from individual states.

*International Center for Settlement of Investment Disputes (ICSID).* See *World Bank*.

*International Lending Supervision Act (ILSA).* Enacted in 1983, the act requires U.S. banking agencies to consult with bank supervisory authorities in other countries to achieve consistent policies and practices in international lending.

*International Monetary Fund (IMF).* A specialized agency of the United Nations, the IMF encourages monetary cooperation, promotes stable exchange policy, and makes short-term advances and standby credits to members experiencing temporary payments difficulties. Its resources come mainly from subscriptions of members.

*International Money Market of the Chicago Mercantile Exchange (IMM).* The IMM is one of the world's largest markets for foreign-currency and Eurodollar futures trading.

*International Swap Derivatives Association*



(ISDA). A trade association for derivative contracts.

**Intervention.** The actions of a central bank designed to influence the foreign-exchange rate of its currency. The bank can use its exchange reserves to buy its currency if it is under too much downward pressure or to sell its currency if it is under too much upward pressure.

**Intracountry foreign-currency exposure.** The risk that exists whenever a subsidiary or a branch lends, invests, places, or extends credit to entities that are located within the same country as the booking unit, but in a currency different from that of the country where the borrower and the booking unit are located.

**Intraday position.** The size of spot and forward positions allowed for a dealer during the business day, which may be larger than that allowed for the end of the date. Sometimes also called “daylight” limits.

**Intrinsic value.** The amount, if any, by which the current market price of the underlying instrument is above the exercise price for calls and below the exercise price for puts.

**Issue price.** The price at which a new issue of securities is placed on sale.

**Joint venture.** The participation of two or more entities in a single business activity. Used to facilitate entry into a market in which other forms of operation may be proscribed.

**Last trading date.** The final day on a futures or options exchange when trading may occur in a given futures contract month or in a given option series.

**Latin American Free Trade Association (LAFTA).** Originally developed to create a common market in Latin America among member countries, it has since been reorganized into the Latin American Integration Association (ALADI). Members include Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela.

**Lead manager.** The commercial or investment bank with the primary responsibility for organizing a syndicated bank credit or bond issue. This includes the recruitment of additional lending or underwriting banks, the negotiation of terms with the borrower, and the assessment of market conditions.

**Lending margin.** The fixed percentage above the reference rate paid by a borrower in a rollover credit or on a floating-rate note.

**Letter of credit—advised.** An export letter of credit issued by a bank that requests another bank to advise the beneficiary that the credit has

been opened in its favor. This occurs when the issuing bank does not have an office in the country of the beneficiary and uses the facilities of the advising bank. The advising bank is potentially liable only for its own error in making the notification.

**Letter of credit—back-to-back.** A letter of credit issued on the strength (or “backing”) of another letter of credit, involving a related transaction and nearly identical terms. For example, ABC company in the United States is designated as the beneficiary of an irrevocable letter of credit confirmed by a U.S. bank to supply XYZ company in Bolivia, whose bank issued the letter of credit, with goods to be purchased from a third company. The third company, however, will not fill ABC’s order unless it receives prepayment for the goods, either through cash or some other type of financing. If ABC is unable to prepay in cash, it will request its bank to issue a letter of credit in favor of the third company. If ABC’s bank agrees, the domestic credit is then “backed” by the foreign letter of credit and a back-to-back letter-of-credit transaction exists.

**Letter of credit—cash.** A letter addressed from one bank to one or more of its correspondents that makes available to a party named in the letter a fixed sum of money up to a future specific date. The sum indicated in the letter is equal to an amount deposited in the issuing bank by the party before the letter is issued.

**Letter of credit—commercial.** A letter addressed by a bank, on behalf of a buyer of merchandise, to a seller authorizing the seller to draw drafts up to a stipulated amount under specified terms and undertaking conditionally or unconditionally to provide payment for drafts drawn.

- **Confirmed irrevocable letter of credit**—A letter in which a bank in addition to the issuing bank is responsible for payment.
- **Irrevocable letter of credit**—A letter in which the issuing bank waives all right to cancel or in any way amend without consent of the beneficiary or seller.
- **Revocable letter of credit**—A letter in which the issuing bank reserves the right to cancel or amend that portion of the amount that has not been demanded before the actual payment or negotiation of drafts drawn.
- **Revolving credit**—A letter in which the issuing bank notifies a seller of merchandise that the amount of credit when used will again

become available, usually under the same terms and without the issuance of another letter.

• *Special clauses*—

— *Green clause*—Similar to the red clause letter of credit below, except that advance payment is made, generally upon presentation of warehouse receipts evidencing storage of the goods.

— *Red clause*—A clause permitting the beneficiary to obtain payment in advance of shipment so that the seller may procure the goods to be shipped.

— *Telegraphic transfer clause*—A clause in which the issuing bank agrees to pay the invoice amount to the order of the negotiating bank upon receipt of an authenticated cablegram from the latter that the required documents have been received and are being forwarded.

*Letter of credit—confirmed.* A letter of credit issued by the local bank of the importer and to which a bank, usually in the country of the exporter, has added its commitment to honor drafts and documents presented in accordance with the terms of the credit. Thus, the beneficiary has the unconditional assurance that, if the issuing bank refuses to honor the draft against the credit, the confirming bank will pay (or accept) it. In many instances, the seller (exporter) may ask that the letter of credit be confirmed by another bank when the seller is not familiar with the foreign issuing bank or as a precaution against unfavorable exchange regulations, foreign-currency shortages, political upheavals, or other situations.

*Letter of credit—deferred payment.* A letter of credit under which the seller's draft specifies that the draft is payable at a later date, for example, 90 days after the bill-of-lading date or 90 days after presentation of the documents.

*Letter of credit—export.* A letter of credit opened by a bank, arising from the financing of exports from a country. The issuing bank may request another bank to confirm or advise the credit to the beneficiary. If confirmed, the credit becomes a confirmed letter of credit, and, if advised, it becomes an advised (unconfirmed) letter of credit.

*Letter of credit—guaranteed.* A letter of credit guaranteed by the customer (applicant) and often backed by collateral security. In domestic banks, the payment of drafts drawn under this credit is recorded in the general-ledger asset account "Customer Liability—Drafts Paid Under

Guaranteed L/C."

*Letter of credit—import.* A letter of credit issued by a bank on behalf of a customer who is importing merchandise into a country. Issuance of an import credit carries a definite commitment by the bank to honor the beneficiary's drawings under the credit.

*Letter of credit—irrevocable.* A letter of credit that cannot be modified or revoked without the customer's consent or that cannot be modified or revoked without the beneficiary's consent.

*Letter of credit—negotiation.* A letter of credit requiring negotiation (usually in the locality of the beneficiary) on or before the expiration date. The engagement clause to honor drafts is in favor of the drawers, endorsers, or bona fide holders.

*Letter of credit—nontransferable.* A letter of credit that the beneficiary is not allowed to transfer in whole or in part to any party.

*Letter of credit—reimbursement.* A letter of credit issued by one bank and payable at a second bank that, in turn, draws on a third bank for reimbursement of the second bank's payment to the beneficiary. Those credits are generally expressed in a currency other than that of the buyer (issuing bank) or the seller, and, because of wide acceptability, many are settled in the United States through yet another bank as the reimbursing agent. Upon issuance, the correspondent sends the reimbursing bank an authorization to honor drawings presented by the negotiating bank.

*Letter of credit—revocable.* A letter of credit that can be modified or revoked by the issuing bank up until the time payment is made.

*Letter of credit—revolving.* A letter of credit issued for a specific amount that renews itself for the same amount over a given period. Usually, the unused renewable portion of the credit is cumulative as long as drafts are drawn before the expiration of the credit.

*Letter of credit—standby.* A letter of credit or similar arrangement, however named or described, that represents an obligation to the beneficiary on the part of the issuer—

- to repay money borrowed by or advanced to or for the account party,
- to make payment on account of any indebtedness undertaken by the account party, or
- to make payment on account of any default by the account party in the performance of an obligation.

*Letter of credit—straight.* A credit requiring presentation on or before the expiration date at the office of the paying bank. The engagement

clause to honor drafts is in favor of the beneficiary only.

*Letter of credit—transferable.* A credit under which the beneficiary has the right to give instructions to the bank called upon to effect payment or acceptance to make the credit available in whole or in part to one or more third parties (second beneficiaries). The credit may be transferred only upon the express authority of the issuing bank and provided that it is expressly designated as transferable. It may be transferred in whole or in part, but may only be transferred once.

*Letter of credit—traveler's.* A letter of credit addressed to the issuing bank's correspondents, authorizing them to negotiate drafts drawn by the beneficiary named in the credit upon proper identification. The customer is furnished with a list of the bank's correspondents. Payments are endorsed on the reverse side of the letter of credit by the correspondent banks when they negotiate the drafts. This type of letter of credit is usually prepaid by the customer.

*Letter of credit—usance.* A letter of credit that calls for payment against time drafts, drafts calling for payment at some specified date in the future. Usance letters of credit allow buyers a grace period of a specified number of days, usually not longer than six months.

*London Interbank Offered Rate (LIBOR).* The rate at which, theoretically, banks in London place Eurocurrencies/Eurodollars with each other.

*London International Financial Futures Exchange (LIFFE).* A London exchange where foreign-currency and Eurodollar futures, as well as foreign-currency options, are traded on spot exchange. LIFFE was taken over by Euronext in 2002 and subsequently merged with the New York Stock Exchange in 2007.

*Limits (bank customer—foreign-exchange and interbank).* Maximum line amounts allowed with other banks for forward exchange transactions, Eurocurrency and Eurodollar transactions, and payments arising from foreign-exchange transactions on the same day.

*Listing.* The formal process required to have a security regularly quoted on an exchange. Eurobonds are usually listed so that they can be purchased by those institutional investors who are constrained to invest in listed securities.

*Local-currency exposure.* The amount of assets and non-balance-sheet items that are denominated in the local currency of that country.

*Lock-up.* The term used to refer to procedures followed in a Eurobond issue to prevent the sale

of securities to U.S. investors during the period of initial distribution.

*Long position.* An excess of assets (and/or forward purchase contracts) over liabilities (and/or forward sale contracts) in the same currency. A dealer's position when the net purchases and net sales leave him or her in a net-purchased position.

*Loro accounts.* Current accounts banks hold with foreign banks in a foreign currency on behalf of their customers.

*Maintenance margin.* The minimum equity a futures exchange requires in a customer's account for each futures contract subsequent to deposit of the initial margin.

*Managed float.* See *Dirty float*.

*Management fee.* The fee received by lead banks as compensation for managing a large-syndicate financing.

*Manager of participation.* The original lender of any loan in which participations are later sold and who generally has a fiduciary relationship with the other lenders. See also *Agent bank*.

*Manager of syndicate.* The bank that solicits the loan from the borrower and solicits other lenders to join the syndicate making the loan.

*Margin.* The amount of money and/or securities that must be posted as a security bond to ensure performance on a contract.

*Marine insurance.* Insurance for losses arising from specified marine casualties. Marine insurance is more extensive than other types as it may provide not merely for losses arising from fire, but also from piracy, wrecks, and most injuries sustained at sea.

- *Average*—A term in marine insurance signifying loss or damage to merchandise.
- *General average*—A loss arising from a voluntary sacrifice of any portion of a shipment or cargo to prevent loss of the whole and for the benefit of all persons at interest. The value of this loss is apportioned not only among all the shippers, including those whose property is lost, but also to the vessel itself. Until the assessment is paid, a lien lies against the whole cargo.
- *Particular average*—A partial loss or damage of merchandise caused by a peril insured against and that does not constitute a general average loss.
- *Free of particular average (F.P.A.)*—Insurance against partial loss regardless of the percentage of the loss.
- *Casco insurance*—Marine insurance on the ship itself (hull) that is usually purchased by



the owners.

- *Cover note*—English equivalent of American binder.
- *Open policy*—A contract between an insurance company and a shipper by which all shipments made by the insured are automatically protected from the time the merchandise leaves the initial shipping point until delivery at destination.

*Mark-to-market.* The revaluation of a traded asset or commodity to reflect the most recently available market price.

*Market-maker.* A bank or other financial institution that gives two-sided (bid and offer) quotations. A market-maker stands prepared to do business on either side of the market without knowing if the inquiring institution intends to buy or sell.

*Market order.* An order that is to be executed immediately at the best available price in the market.

*Matched.* A forward purchase is matched when it is offset by a forward sale for the same date or vice versa. As a necessity, however, when setting limits for unmatched positions, a bank may consider a contract matched if the covering contract falls within the same week or semimonthly period.

*Maturity date.* The settlement date or delivery date for a forward contract.

*Medium-term notes.* Intermediate-term notes that carry a maturity between nine months and ten years.

*Merchant bank.* A European form of an investment bank.

*Money market.* A wholesale market for low-risk, highly liquid, short-term debt instruments.

*Multicurrency line.* A line of credit that gives the borrower the option of using any of the readily available major currencies.

*Multilateral exchange contract.* An exchange contract involving two foreign currencies against each other, for example, a contract for U.S. dollars against Swiss francs made in London or a contract for British pounds against Japanese yen made in New York. Also called an arbitrage exchange contract.

*Multinational bank.* A commercial bank engaged in selling services or conducting operations in more than one country.

*Nationalization.* The act whereby a central government assumes ownership and operation of private enterprises within its territory.

*Negative interest.* A fee charged by a bank for accepting a deposit from a customer. This can

happen when a currency is under pressure to appreciate. A central bank in this situation can establish capital-import controls and limit the amount of deposits that a bank can receive from nonresidents. If market participants want to deposit more money in the country than the central bank will allow, interest rates will drop initially to zero and, if the pressure continues, produce negative interest. Any taxes that a central bank may impose on foreign deposits can also create negative interest.

*Negative pledge.* A contractual promise by a borrower in a syndicated loan or a bond issue not to undertake some future action. One typical negative pledge is that future new creditors will not be given rights greater than those of existing creditors.

*Negotiable instruments.* Written orders or promises to pay that may be transferred by endorsement or delivery, for example, by checks, bills of exchange, drafts, and promissory notes. Governed by article 3 of the Uniform Commercial Code.

*Negotiate.* (1) Letters of credit—To verify that the documents presented under a letter of credit conform to requirements and then, if the documents are in order, to pay the seller of the goods. (2) Negotiable instruments—To transfer possession of an instrument by a person other than the issuer to another person who thereby becomes its holder.

*Net accessible interest differential.* The difference between the interest rates that can actually be obtained on two currencies. This difference is usually the basis of the swap rate between the two currencies and, in most cases, is derived from external interest rates rather than domestic ones. These external rates, or Euro-rates, are free from reserve requirements (which would increase the interest rate) and from exchange controls (which would limit access to the money).

*Net exchange position.* An imbalance between all the assets and purchases of a currency, and all the liabilities and sales of that currency.

*Net position.* A bank has a net position in a foreign currency when its assets (including future contracts to purchase) and liabilities (including future contracts to sell) in that currency are not equal. An excess of assets over liabilities, including future contracts, is called a net “long” position, and liabilities in excess of assets result in a net “short” position. A net long position in a currency that is depreciating results in a loss because, with each day, the position is convert-

ible into fewer units of local currency. A net short position in a currency that is appreciating represents a loss because, with each day, satisfaction of the position costs more units of local currency.

*Netting arrangement.* Agreement by two counterparties to examine all contracts settling in the same currency on the same day and to agree to exchange only the net currency amounts. Also applies to net market values of several contracts.

*Nominal interest rate.* The interest rate stated as a percentage of the face value of a loan. Depending on the frequency of interest collection over the life of the loan, the nominal rate may differ from the effective interest rate.

*Nonrevolving.* A line of credit that cannot be reused once it has been drawn down to a specified amount.

*Nostro accounts.* Demand accounts of banks with their correspondents in foreign countries in the currency of that country. These accounts are used to make and receive payments in foreign currencies for a bank's customers and to settle maturing foreign-exchange contracts. Also called due from foreign bank—demand accounts, our balances with them, or due from balances.

*Novation.* The substitution of a new party for one of the original parties to a contract. The result is a new contract with the same terms, but at least one new party.

*Odd dates.* Deals within the market are usually for spot, one month, two months, three months, or six months forward. Other dates are odd dates, and prices for them are frequently adjusted with more than a mathematical difference. Hence, most market deals are for regular dates, although commercial deals for odd dates are common.

*Offer rate.* The price at which a quoting party is prepared to sell or lend currency. This is the same price at which the party to whom the rate is quoted will buy or borrow if it desires to do business with the quoting party. The opposite transactions take place at the bid rate.

*Offering circular.* A document giving a description of a new securities issue, as well as a description of the entity making the issue.

*Office of Foreign Asset Control (OFAC).* An office within the U.S. Treasury Department that administers U.S. laws imposing economic sanctions against targeted hostile foreign countries. While OFAC is responsible for administration of these statutes, all of the bank regulatory agencies cooperate in ensuring compliance.

*Official rate.* The rate established by a country at which it permits conversion of its currency into that of other countries.

*Offshore branch.* Banking organization designed to take advantage of favorable regulatory or tax environments in another country. Many of these operations are shell branches with no physical presence.

*Offshore dollars.* The same as Eurodollars, but encompassing the deposits held in banks and branches anywhere outside of the United States, including Europe.

*Open contracts (open positions).* The difference between long positions and short positions in a foreign currency or between the total of long and short positions in all foreign currencies. Open spot or open forward positions that have not been covered with offsetting transactions. See also *Net position*.

*Open interest.* The total number of futures contracts for a particular asset that have not been liquidated by an offsetting trade or that have not been fulfilled by delivery.

*Open market operations.* Purchases or sales of securities or other assets by a central bank on the open market.

*Open position limit.* A limit placed on the size of the open position in each currency to manage off-balance-sheet items.

*Opening bank.* The bank that draws up and opens the letter of credit and that makes payment according to the conditions stipulated.

*Option contract.* A contract giving the purchaser the right, but not the obligation, to buy (call option) or sell (put option) an asset at a stated price (strike or exercise price) on a stated date (European option) or at any time before a stated date (American option).

*Organisation for Economic Co-operation and Development (OECD).* Founded as a successor organization to the Organization for European Economic Cooperation (OEEC). The OEEC was originally established to administer aid under the Marshall Plan during the post-World War II period. The goals of the successor OECD are to stimulate world trade, economic growth, and economic development. Members include Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

*Organization of American States (OAS).* An

organization of 35 independent states of the Americas formed to promote intergovernmental cooperation in the Western Hemisphere.

*Organization of the Petroleum Exporting Countries (OPEC).* A federation of oil-exporting countries that sets petroleum prices for member countries. Members include Algeria, Angola, Ecuador, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela.

*Out-of-the-money.* A term used to refer to a call option whose strike price is above or to a put option whose strike price is below the current price of the asset on which the option is written.

*Outright.* Forward exchange bought and sold independently from a simultaneous sale or purchase of spot exchange.

*Outright forward rate.* A forward exchange rate that is expressed in terms of the actual price of one currency against another, rather than, as is customary, by the swap rate. The outright forward rate can be calculated by adding the swap premium to the spot rate or by subtracting the swap discount from the spot rate.

*Overbought.* The position of a trader who has bought a larger amount of a commodity or asset than he or she has sold.

*Overnight.* A swap transaction involving same-day settlement of the spot transaction against a value date of the next business day on the forward contract.

*Overnight position.* A foreign-exchange or money market position maintained overnight. There is more risk involved in this position than in one maintained during the day because political and economic events may take place at night when the operator cannot react immediately to them.

*Override limit.* The total amount of money (measured in terms of a bank's domestic currency) that the bank is willing to commit to all foreign-exchange net positions.

*Oversold.* The position of a trader who has sold a larger amount of a certain asset or commodity than he or she has bought.

*Over-the-counter (OTC).* Transactions not conducted in an organized exchange. OTC markets have no fixed location or listing of products.

*Paris Club.* An ad hoc group of western creditor governments that meets informally under the chairmanship of the French Treasury. Its function is to start the process of rescheduling a country's official debt.

*Parity.* A term derived from par, meaning the equivalent price for a certain currency or security relative to another currency or security, or relative to another market for the currency or security after making adjustments for exchange rates, loss of interest, and other factors.

*Parity grid.* The system of fixed bilateral par values in the European Monetary System. The central banks of the countries whose currencies are involved in an exchange rate are supposed to intervene in the foreign-exchange market to maintain market rates within a set range defined by an upper and a lower band around the par value.

*Participation.* The act of taking part in a syndicated credit or a bond issue.

*Par value.* The official parity value of a currency relative to the dollar, gold, Special Drawing Rights, or another currency.

*Paying agent.* A bank or syndicate of banks responsible for paying the interest and principal of a bond issue to bondholders on behalf of the bond issuer.

*Performance bond.* A bond supplied by one party to protect another against loss in the event of the default of an existing contract.

*Placement memorandum.* A document in a syndicated Eurocredit that sets out details of the proposed loan and gives information about the borrower.

*Political risk.* Political changes or trends, often accompanied by shifts in economic policy, that may affect the availability of foreign exchange to finance private or public external obligations. The banker must understand the subtleties of current exchange procedures and restrictions, as well as the possibilities of war, revolution, or expropriation in each country with which the bank transacts business, regardless of the actual currencies involved. See also *Country Risk*.

*Portfolio investment.* An investment in an organization, other than a subsidiary or joint venture, in which less than 20 percent of the voting shares are held.

*Position.* A situation created through foreign-exchange contracts or money market contracts in which changes in exchange rates or interest rates could create profits or losses for the operator.

*Position book.* A detailed, ongoing record of

an institution's dealings in a particular foreign currency or money market instrument.

*Position risk.* See *Net position*.

*Position-trader.* A speculator in the futures market who takes a position in the market for a period of time.

*Premium.* The adjustment to a spot price that is made in arriving at a quote for future delivery. If a dealer were to quote \$2.00 and \$2.05 (bid and asked) for sterling, and the premiums for six months forward are 0.0275 and 0.0300, the forward quotes would be adjusted to \$2.0275 and \$2.0800. The premium usually represents differences in interest rates for comparable instruments in two countries. However, in periods of crisis for a currency, the premium may represent the market anticipation of a higher price.

*Price quotation system.* A method of giving exchange rates in which a certain specified amount of a foreign currency (1 or 100, usually) is stated as the corresponding amount in local currency.

*Primary dealers.* Securities firms that are recognized by the Federal Reserve System to buy and sell securities with the Fed.

*Private placement.* The process of negotiating for the sale of securities, debt, equity, or a combination thereof to a relatively small group of investors.

*Protest.* The formal legal process of demanding payment of a negotiable item from the maker or drawee who has refused to pay.

*Public Law (P.L.) 480.* The most common reference to the Agricultural Trade Development and Assistance Act of 1954. Generally, P.L. 480 authorizes the President to provide various types of assistance to American agricultural exporters, such as making sales in the currency of the destination country.

*Put.* The ability of the bank to require repayment of the debt of a borrower by a third party because of nonperformance of the borrower through an agreement other than a formal guarantee.

*Put option.* A contract giving the purchaser the right, but not the obligation, to sell a particular asset at a stated strike price on or before a stated date.

*Rate risk.* In the money market, the chance that interest rates may rise when an operator has a negative money market gap (a short position) or that interest rates may go down when the operator has a positive money market gap (a long position). In the exchange market, the

chance that the spot rate may rise when the trader has a net oversold position (a short position), or that the spot rate may go down when the operator has a net overbought position (a long position).

*Rate swap.* A transaction in which one participant pays a fixed rate of interest on a notional amount for a given period of time and the other pays a floating rate.

*Reciprocal rate.* The price of one currency in terms of a second currency, when the price of the second currency is given in terms of the first.

*Recourse.* The ability to pursue judgment for a default on a negotiable instrument against parties who signed the note.

*Representations.* Statements made by a borrower in a syndicated credit or bond issue describing the borrower's financial condition.

*Representative office.* A facility established in U.S. or foreign markets by a bank to sell its services and assist clients; in the United States, these offices cannot accept deposits or make loans.

*Repurchase agreement (repo or RP).* A holder of assets sells those assets to an investor with an agreement to repurchase them at a fixed price on a fixed date. The security "buyer" in effect lends the "seller" money for the period of the agreement, and the terms of the agreement are structured to compensate the buyer for this. Dealers use repo extensively to finance their positions.

*Reserve account.* Those items in the balance of payments that measure changes in the central bank's holdings of foreign assets (such as gold, convertible securities, or Special Drawing Rights).

*Reserve currency.* A foreign currency held by a central bank (or exchange authority) for the purposes of exchange intervention or the settlement of intergovernmental claims.

*Reserve requirements.* Obligations imposed on commercial banks to maintain a certain percentage of deposits with the central bank or in the form of central-bank liabilities.

*Retiming.* Restructuring of the timing of interest payable on bonds.

*Revaluation.* An official act wherein the parity of a currency is adjusted relative to the dollar, gold, Special Drawing Rights, or another currency, resulting in less revalued units relative to those currencies. (See also *Devaluation*.) Also, the periodic computations of the current values (revaluations) of ledger accounts and unmatured future purchase and sales contracts.

*Revolving credit.* A line of bank credit that may be used at the borrower's discretion. Interest is paid on the amount of credit actually in use, while a commitment fee is paid on the unused portion.

*Revolving into term.* A commitment that allows a revolving line of credit (usually one to three years) with term provision at the expiration of the revolver for an additional period of time. Most common is a two-year revolver with a five-year, fully amortizing term portion.

*Revolving line of credit.* A line of credit that permits successive drawings and payments at the borrower's discretion. The funds available to the borrower are replenished by any payments of principal.

*Risk-management tools.* Financial devices (such as futures or options) that permit a borrower or lender of funds to protect against the risks of changing currency prices and/or interest rates.

*Risk participation.* An agreement whereby a bank shares the risk in an outstanding credit or instrument. Credit-equivalent amounts of risk participations are assigned based on the risk category appropriate to the account party obligor or, if relevant, to the nature of the collateral or guarantees. Usually treated as a direct credit substitute.

*Rollover.* The process of selling new securities to pay off old ones coming due, refinancing an existing loan, or extending a maturing forward foreign-exchange contract.

*Rollover credit.* A bank loan with an interest rate periodically updated to reflect market interest rates. The interest rate in the loan for each subperiod is specified as the sum of a reference rate and a lending margin.

*Rollover date.* The end of an interest period in a revolving term loan.

*Same-day funds.* Federal funds, or the equivalent, used in the settlement of a transaction that will probably create an interest adjustment of the trading rate to compensate for the difference in the availability of the funds for use.

*Samurai bonds.* Yen-denominated bonds issued by a foreign borrower in Japan.

*Scalpers.* Floor or pit traders in the futures market with short-term horizons who sell slightly above the most recent trade and buy at a price slightly below.

*Seasoned securities.* Securities that have traded in the secondary market for more than 90 days.

*Secondary market.* A market in which secu-

rities are traded following the time of their original issue.

*Selling concession.* The share of total investment-banking fees accruing to the selling group.

*Selling group.* All banks involved in selling or marketing a new issue of bonds. Sometimes the term is used in reference to dealers acting only as sellers and is intended to exclude reference to underwriters or managers.

*Seller's option contract.* A contract in which the seller has the right to settle a forward contract at his or her option anytime within a specified period. See also *Option contract*.

*Selling rates.* Rates at which dealers are prepared to sell foreign exchange in the market.

*Settlement day.* The day on which the actual transfer of two currencies or the transfer of money for an asset takes place at a previously arranged price.

*Settlement price.* The official daily closing price for a futures or option contract. This price is established and used by a clearinghouse to determine each clearing firm's settlement variation.

*Settlement risk.* The possibility that a seller of foreign exchange or securities, having collected the payment in local currency, may fail to deliver the exchange or securities to the buyer.

*Settlement variation.* The sum of all changes in amount for each of a firm's futures or options positions as calculated from each day's settlement price. This amount is paid to or received from the clearinghouse each day based on the previous day's trading.

*Shell branch.* See *Offshore branch*.

*Shogun bonds.* Foreign bonds issued in Tokyo and denominated in currencies other than the Japanese yen. The usual denomination is the U.S. dollar.

*Short position.* An excess of liabilities (and/or forward sale contracts) over assets (and/or forward purchase contracts) in the same currency. A dealer's position when the net of purchases and sales leaves the trader in a net-sold or oversold position.

*Sight draft.* A draft payable upon presentation to the drawee or within a brief period thereafter known as "days of grace."

*Society for Worldwide Interbank Financial Telecommunications (SWIFT).* A telecommunications network established by major financial institutions to facilitate messages among SWIFT participants. These messages typically result in

a monetary transaction between institutions. The network is based in Brussels.

*Soft currency.* A currency that is not freely convertible into other currencies.

*Soft loans.* Loans with exceptionally lenient repayment terms, such as low interest, extended amortization, or the right to repay in the currency of the borrower.

*Sole of exchange.* A phrase appearing on a draft to indicate that no duplicate is being presented.

*Sovereign risk.* The risk that the government of a country may interfere with the repayment of debt.

*Space arbitrage.* The buying of a foreign currency in one market and the selling of it for a profit in another market.

*Special Drawing Rights (SDRs).* International paper money created and distributed to governments by the IMF in quantities dictated by special agreements among its member countries. The value of SDRs is determined by the weighted value of a “basket” of major currencies.

*Specially designated nationals.* Persons or entities listed by OFAC. These persons or entities are typically front organizations and are subject to OFAC prohibitions. See also *Blocked account, Office of Foreign Asset Control.*

*Speculation.* The purchase or sale of a trading unit, usually on a forward basis, in hopes of making a profit at a later date. The term is used in the foreign-exchange, commodity, stock, and option markets.

*Spot contract.* A foreign-exchange contract traded in the interbank market in which the value date is two business days from the trade date.

*Spot exchange (or spot currency).* Foreign exchange purchased or sold for immediate delivery and paid for on the day of the delivery. Immediate delivery is usually considered delivery in one to two business days after the conclusion of the transaction. Many U.S. banks consider transactions maturing in as many as ten business days as spot exchange. Their reasons vary but are generally to facilitate revaluation accounting policies and to initiate final confirmation and settlement verification procedures on future contracts nearing maturity. See also *Futures (or forward) exchange contract.*

*Spot month.* The futures-contract month that is also the current calendar month.

*Spot/next.* In the foreign-exchange market, a term used to describe a swap transaction for value on the spot date with the reverse trans-

action taking place the next working day after the spot date. In the Eurocurrency market, a term used to describe a loan or deposit for value on the spot date with maturity on the next working day after the spot date.

*Spot transaction.* A transaction for spot exchange or currency.

*Spread.* The difference between the bid rate and the offer rate in an exchange-rate quotation or an interest quotation. This difference is not identical with the profit margin because traders seldom buy and sell at their bid and offer rates at the same time. In another sense (for example, Eurodollar loans priced at a mark-up over LIBOR), spread means a mark-up over cost, and, in this context, the spread is identical with the profit margin.

*Square exchange position (or square-off).* To make the inflows of a given currency equal to the outflows of that currency for all maturity dates. This produces a square exchange position in that currency.

*Stabilization.* The efforts by a lead manager in a securities issue to regulate the price at which securities trade in the secondary market, during the period that the securities syndicate is still in existence.

*Sterilization.* Intervention in the foreign-exchange market by a central bank in which the change in the monetary base caused by the foreign-exchange intervention is offset by open market operations involving domestic assets.

*Straight bill of lading.* A bill of lading drawn directly to the consignee and therefore not negotiable. See also *Bill of lading.*

*Strike price.* The price at which an option buyer may purchase (if a call option) or sell (if a put option) the asset upon which the option is written.

*Subscription agreement.* An agreement between a securities issuer and the managing banks that describes the terms and conditions of the issue and the obligation of the parties to the agreement.

*Subscription period.* The time period between the day on which a new securities issue is announced and the day on which the terms of the issue are signed and the securities are formally offered for sale.

*Subsidiary.* Entity in which a bank has a modicum of control. Used to facilitate entry into foreign markets in which other operations are proscribed.

*Sushi bonds.* Dollar-denominated Eurobonds issued by Japanese companies and purchased

primarily by Japanese investors. These bond issues are typically managed by Japanese banks.

*Swap.* The combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another. The trading of one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange is made and the forward contract matures. See also *Swap cost (or profit)*.

*Swap arrangement—reciprocal.* A bilateral agreement between central banks enabling each party to initiate swap transactions up to an agreed limit to gain temporary possession of the other party's currency.

*Swap cost (or profit).* In a swap transaction, the cost or profit related to the temporary movement of funds into another currency and back again. That exchange cost or profit must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. Furthermore, the true trading profits or losses generated by the foreign-exchange trader cannot be determined if swap profits or costs are charged to the exchange function rather than allocated to the department whose loans or investments the swap actually funded.

*Swap and deposit.* A combination of swap transactions that enables the borrower to have use of both currencies for the duration of the transaction.

*Swap position.* A situation in which the scheduled inflows of a given currency are equal to the scheduled outflows, but the maturities of those flows are purposely mismatched. The expectation in a swap position is that the swap rate will change and that the gap can be closed at a profit.

*Swap rate.* The difference between the spot exchange rate of a given currency and its forward exchange rate.

*Swap-swap.* A swap transaction involving one forward maturity date against another forward maturity date.

*Swaption.* An option on a swap. It gives the buyer the right, but not the obligation, to enter into an interest-rate swap at a future period of time.

*Syndicate.* A group of banks that acts jointly, on a temporary basis, to loan money in a bank credit (syndicated credit) or to underwrite a new issue of bonds (bond underwriting syndicate).

*Syndicate leader.* See *Manager of syndicate*.

*Syndicate participation.* Usually, a large credit arranged by a group of lenders, each of whom advances a portion of the required funds. It

differs from a participation loan because the banks participate at the outset and are known to the borrower.

*Take-down.* The receipt of the principal of a loan by the borrower.

*Tariff.* A duty or tax on imports that can be either a percentage of cost or a specific amount per unit of import.

*Telegraphic transfer (TT) rate.* The basic rate at which banks buy and sell foreign exchange. Buying rates for mail transfers, foreign-currency drafts, traveler's checks, and similar instruments are all based on the TT rate. The TT rate may be slightly less favorable than other rates because of the time required for collection. Foreign-currency time (usance) drafts also are bought at the TT rate, but interest to maturity is deducted for the time which must elapse until maturity.

*Telex.* Direct communication between two banks or companies and organizations via satellite or underwater cable.

*Tenor.* A term designating payment of a draft as being due at sight, a given number of days after sight, or a given number of days after the date of the draft.

*Term structure.* The level of interest rates on debt instruments of a particular type, viewed as a function of term to maturity. The interest-rate level may rise or fall with increasing maturity.

*Terms of trade.* Relative price levels of goods exported and imported by a country.

*Test key.* A code used in transferring funds by cable or telephone so that the recipient may authenticate the message. A test key generally consists of a series of numbers, including a fixed number for each correspondent bank; a number for the type of currency; a number for the total amount; and, possibly, numbers for the day of the month and day of the week. A single number code indicates whether the total amount is in thousands, hundreds, tens, or digits. To arrive at a test number, the indicated numbers are totaled, and the total amount usually precedes the text of the message.

*Third-country bills.* Banker's acceptances issued by banks in one country that finance the transport or storage of goods traded between two other countries.

*Tied loan.* A loan made by a governmental agency that requires the borrower to spend the proceeds in the lender's country.

*Time draft.* A draft drawn to mature at a fixed time after presentation or acceptance.

*Time value.* The amount by which an option's market value exceeds its intrinsic value.



**Tombstone.** In a syndicated credit, an advertisement placed in a newspaper or magazine by banks to record their participation in the loan or, in a bond issue, to record their role in managing, underwriting, or placing the bonds.

**Tomorrow next (tom/next).** The simultaneous purchase and sale of a currency for receipt and payment on the next and second business day, respectively, or vice versa.

**Tradable amount.** The minimum amount accepted by a foreign-exchange broker for the interbank market, for example, 100,000 Canadian dollars or 50,000 pounds sterling.

**Trade acceptance.** A draft drawn by the seller (drawer) on the buyer (drawee) and accepted by the buyer. Also called a trade bill, customer acceptance, and two-name trade paper. See also *Acceptance*.

**Trade accounts.** Those parts of the balance of payments that reflect money spent abroad by the citizens of a country on goods and services and the money spent by foreigners in the given country for goods and services.

**Trader's (or dealer's) ticket (slip).** The handwritten record of a foreign-exchange trade and/or placing and taking of deposits that is written by the dealer who executed the transaction.

**Trading position worksheet.** A record of incomplete transactions in a particular currency.

**Tranche.** One of a number of drawings of funds made by a borrower under a term loan.

**Transaction date.** The date on which a contract's terms are negotiated and agreed on.

**Transfer risk.** The risk arising when a borrower incurs a liability in a currency that is not the currency in which revenues are generated. The borrower may not be able to convert its local currency to service an international loan if foreign exchange is not generated.

**Trending of rates.** Quoting a slightly higher or lower two-way rate in order to reflect a preference for either purchasing or selling.

**Trust receipt.** Used extensively in letter-of-credit financing, this is a document or receipt in which the buyer promises to hold the property received in the name of the releasing bank, although the bank retains title to the goods. The merchant is called the trustee, the bank the entruster. Trust receipts are used primarily to allow an importer to take possession of the goods for resale before payment to the issuing bank.

**Two-way quotation.** A simultaneous quotation of foreign-exchange buying and selling rates implying the willingness of the bank to deal either way.

**Two-way rate.** An exchange-rate or an interest-rate quotation that contains both a bid rate and an offer rate. The size of the spread between the two rates indicates the relative quality of the quotation.

**Unconfirmed letter of credit.** See *Letter of credit—advised*.

**Undervalued.** Decline of the spot rate below purchasing power parities, so that the goods of one county are cheaper than in another country. In relation to forward exchange, "undervalued" means that forward premiums are narrower or forward discounts are wider than the interest parities between the two financial centers.

**Underwriting allowance.** The share of total investment-banking fees accruing to the underwriting group.

**Underwriting syndicate.** The banks, in a new securities issue, that agree to pay a minimum price to the borrower even if the securities cannot be sold on the market at a higher price.

**Uniform customs and practices for documentary credits.** Sets of rules governing documentary letters of credit formulated by the International Chamber of Commerce. Includes general provisions, definitions, forms, responsibilities, documents, and the transfer of documentary letters of credit.

**Unmatched.** A forward purchase is unmatched when a forward sale for the same date has not been executed or vice versa.

**Unmatured transactions.** Trading transactions that have not reached their settlement dates.

**Usance.** The period of time between presentation of a draft and its maturity. See also *Tenor*.

**Value-compensated.** The payment or collection of a settlement cost on an open forward contract to cancel the contract rather than to execute an offsetting contract for the same maturity date.

**Value date.** The date on which foreign exchange bought and sold must be delivered and on which the price for the exchange must be paid.

**Value-impaired.** A category assigned by the Interagency Country Exposure Review Committee that indicates a country has protracted debt problems.

**Value today.** An arrangement by which spot exchange must be delivered and paid for on the day of the transaction instead of two business days later.

**Value tomorrow.** An arrangement by which spot exchange must be delivered and paid for on



the business day following the transaction instead of two business days after the transaction.

*Variation margins.* Positive or negative changes in the value of a security bought on margin or a futures contract. These variations must be paid daily in cash. All securities bought or sold on margin and futures contracts are marked to market.

*Volatility.* The standard deviation of changes in the logarithm of an asset price, expressed at a yearly rate. The volatility is a variable that appears in option formulas.

*Volume quotation system.* A method of giving exchange rates in which a certain specified amount of local currency (usually 1 or 100) is stated as the corresponding amount in foreign currency.

*Vostro account.* A demand account maintained for a bank by a correspondent bank in a foreign country. The nostro account of one bank is the vostro account of the other bank. See also *Nostro account*.

*Warehouse receipt.* An instrument that lists and is a receipt for goods or commodities deposited in the warehouse that issues the receipt. These receipts may be negotiable or non-negotiable. A negotiable warehouse receipt is made to the “bearer,” while a nonnegotiable warehouse receipt specifies precisely to whom the goods shall be delivered. There are several alternatives for releasing goods held under warehouse receipts: (1) the delivery of goods may be allowed only against cash payment or substitution of similar collateral; (2) some or all of the goods may be released against the trust receipt without payment, or (3) a warehouseman may release a stipulated quantity of goods without a specific delivery order. Banks will accept a warehouse receipt as collateral for a loan only if the issuer of a receipt is a bonded warehouseman. The bank must have protected assurances for the authenticity of the receipt and the fact that the commodities pledged are fully available as listed on the warehouse receipt.

*Wash.* A transaction that produces neither profit nor loss.

*Wire.* Often the words “wire” and “cable” are used interchangeably. In some cases, “wire” denotes messages sent within the confines of the United States, and “cable” refers to messages transmitted overseas. Others use “wire” to mean a transfer of funds by telephone rather than by

cable, telex, or telegram.

*Withholding tax.* A tax imposed by a country on the gross amount of payments to a foreign lender from an in-country borrower.

*Within-line facility (or facilities).* Subfacilities of the line of credit that establish parameters, terms, and conditions of various other facilities available for specific additional purposes or transactions. The aggregate sum of all outstandings under within-line facilities must not exceed the total of the overall line of credit.

*World Bank (The International Bank for Reconstruction and Development).* An international financial organization whose purpose is to aid the development of productive facilities in member countries, particularly in developing countries. The chief source of funds is capital contributions made by member countries, which vary with the financial strength of the country. Another funding source is the sale of long-term bonds.

*Writer.* An individual who issues an option and, consequently, has the obligation to sell the asset (if the option is a call) or to buy the asset (if the option is a put) on which the option is written if the option buyer exercises the option.

*Yankee bond.* A dollar-denominated foreign bond issued in the U.S. market.

*Yield curve.* The interest rates for each different tenor or maturity of a financial instrument. A graph of the yield curve has interest rates on the vertical axis and time-to-maturity on the horizontal axis. When longer maturities have higher interest rates than shorter maturities, the curve is called a positive or upward-sloping yield curve. The opposite type of curve is called a negative, downward-sloping, or inverted yield curve. When interest rates are the same for all maturities, the curve is called a flat yield curve. See also *Term structure*.

*Yield to maturity.* The rate of interest on a bond when calculated as that rate of interest which, if applied uniformly to future time periods, sets the discounted value of future bond coupon and principal payments equal to the current market price of the bond.

*Zero coupon bond.* A bond that pays no interest but that is redeemed at its face value at maturity.

Although the methods of international loan portfolio management are similar to those established for domestic lending, the additional risks in international lending require specialized expertise and careful management by the bank. Banks conducting international lending activities should establish strong policies that include not only the basic components found in domestic policies but also the following segments.

*Geographic limits.* The bank should delineate those countries or geographic areas where it can lend profitably and soundly in accordance with its objectives and in consideration of country risks. International lending officers must know the specific country limits established by the board of directors, and the bank should have a monitoring system to ensure adherence to those limits. The limits established will depend on each bank's available financial resources, the qualifications and skills of its staff, the extent of its lending activities, and its further growth potential.

*Distribution by category.* Limitations based on aggregate percentages of total international loans in real estate, consumer credit, ship financing, or other categories are common. Although loan distribution policy may differ among banks, international loans are generally granted in the following categories:

- import and export financing
- loans to corporations or their overseas branches, subsidiaries, or affiliates with a parent guarantee or other form of support
- loans granted to foreign local borrowers including foreign entities of U.S. concerns that borrow without any form of support from the parent corporation
- loans and placements to foreign banks or to overseas branches of U.S. banks
- loans to foreign governments or foreign governmental entities

The categories of credit extensions that the bank's international division should engage in and the nature of any limitations will depend on the particular bank and its customers. Deviations from policy limitations that have been approved by the board of directors or its designated committee(s) should be allowed to meet the changing requirements of the bank's custom-

ers. During times of heavy loan demand in one category, an inflexible loan distribution policy could cause that category to be slighted in favor of another.

*Types of credits.* The lending policy should state the types of international credits that the bank can make and set guidelines to follow in granting specific credits. The decision about the types of credits to be granted should be based on consideration of the expertise of the lending officers, deposit structure of the bank, and anticipated credit needs of its customers. Complex credits requiring more than normal policing should be avoided unless or until the bank obtains the necessary personnel to administer those credits properly. Types of credit that have resulted in an abnormal loss to the bank's international division should be controlled or avoided within the framework of stated policy. Syndications and other types of term loans should be limited to a given percentage of the bank's stable funds.

*Maximum maturities.* International credits should be granted with realistic repayment plans. Maturity scheduling should be related to the anticipated source of repayment, the purpose of the credit, the useful life of the collateral, and the degree of country risk. For term loans, a lending policy should state the maximum number of months during which loans may be amortized. Specific procedures should be developed for situations requiring balloon payments and modifications to the original terms of a loan. If the bank requires a cleanup (out-of-debt) period for lines of credit, that period should be explicitly stated.

*Loan pricing.* Interest rates, fees, commissions, and discounts on various loan types established by the loan policy must be sufficient to cover the costs of funds loaned, servicing of the loan (including general overhead), and probable losses, while providing for a reasonable rate of return. Periodic review allows the rates to be adjusted to account for changes in costs and competitive factors. Additionally, the bank must establish practices to ensure a continuous examination of the relationships between loan pricing and the cost of funds.

*Foreign-exchange risks.* Lending policy should include controls that minimize risks for loan

portfolios in one currency funded by borrowings in another. These activities must be identified and should be limited by the bank if—

- a particular foreign government is expected to impose stringent exchange controls;
- the currencies involved are or will be subject to wide exchange-rate fluctuations; or
- political, social, or economic developments are likely to intensify exchange risks.

Multicurrency credit commitments permit borrowers to select from a specific list of currencies the one they prefer to use in each rollover period. The listed currencies, however, may be unavailable or available only at a high cost. The bank should protect itself by stating in the loan agreement that its requirement to provide any of the currencies listed is subject to availability at the time requested by the borrower. For detailed information on foreign-exchange risks, see section 7100, “International—Foreign Exchange.”

*Documentation and collateral.* Trade financing often represents a significant amount of an international division’s lending activity. In this type of financing, the bank deals only in documents, while its customer is responsible for the merchandise under the terms of the sales contract. The bank’s control of documents, especially title documents, is crucial. Lending officers and applicable personnel, therefore, must be knowledgeable in handling documentation, which may be the bank’s ultimate support for certain transactions.

The bank must establish policies for taking overseas collateral as security for a loan to ensure that local required procedures are met. For example, in many countries, liens on fixed assets must be registered with the local government, depending on the type of asset. Lending against current assets also requires special care and monitoring. The bank must know which countries do not recognize the legality of trust receipts as recognized in the United States. In other countries, borrowers sign powers of attorney or similar documents permitting lenders to take specifically defined collateral at any time. For these and other reasons, the bank must retain local lawyers who are thoroughly familiar with that country’s laws, regulations, and practices and who will check loan agreements, guarantees, debt instruments, drafts, corporate resolutions, and other loan documentation. There are

significant differences between loan agreements drawn in the United States and those drawn abroad. Nevertheless, the bank must ensure that its loan agreements with borrowers protect it adequately. Generally, few restrictive covenants are required for international loans because of competition in offshore markets and differing local practices. Nevertheless, the bank should insist on protective covenants when appropriate, especially if the borrowers are small or medium-sized obligors. The bank also should ensure that loan agreements provide for the borrower to reimburse the lender for certain unanticipated costs, including the imposition of taxes on interest withheld at the source without corresponding credits gained on the levy of U.S. taxes and the need to establish or increase bad debt reserves.

*Financial information.* Current and complete financial information is necessary at the inception and throughout the term of an international loan. The lending policy should specifically define financial-statement requirements for businesses, foreign banks, foreign governments, other foreign public-sector entities, and individuals, and it should include criteria for the requirement of audited, nonaudited, fiscal, interim, operating, cash-flow, and other statements. The requirements should be defined clearly enough so that any credit data exception in the examination report is a clear exception to the bank’s lending policy.

The reliability of financial statements and accompanying information differs greatly among countries. In some countries, accounting standards and traditions are lax and audited statements are virtually unknown. Financial information provided for tax-collection purposes in foreign countries may differ from that given in confidence to the bank to obtain credit.

In analyzing financial statements of foreign entities, factors are present that do not exist when analyzing those of U.S. enterprises, such as markedly different accounting concepts, the wide use of “hidden reserves,” translation problems, different methods of valuing assets, or unfamiliar and sharply different legal principles. A general rule in analyzing local currency statements is not to translate figures to U.S. dollar equivalents. Fluctuating exchange rates can have a significant impact on the analysis of U.S. dollar equivalents over a period of time. If a loan is to be repaid in currency other than the borrower’s domestic currency, an analysis of

probable future foreign-exchange-rate movements is necessary to assess the borrower's ability to generate sufficient local currency to buy the necessary exchange. An analysis of the availability of exchange is also required to ensure full repayment at maturity. Financial Accounting Standards Board Statement No. 52, "Foreign-Currency Translation," takes certain translation adjustments out of earnings and places them in a separate component of equity capital ("foreign-currency translation adjustments"), thereby reducing the fluctuations in earnings produced by changing exchange rates. Since the financial information provided is not always reliable, the bank's policies should enable it to determine by other means the capacity, integrity, experience, and reputation of the foreign borrower.

Extensions of credit to foreign banks constitute an important segment of an international division's foreign loans. It is important to obtain information on the nature of the bank's business; its assets, liabilities, and contingent accounts; and its record of past earnings. A review of these data should lead to a determination of the strength of the bank and its ability to meet its obligations in the foreseeable future. At minimum, this review should include—

- the size and liquidity of primary and secondary reserves;
- the nature of lending activities, including types and terms of loans, extent of collateral held, and loss experience;
- lending policies and controls in effect to ensure compliance with applicable lending laws and regulations;
- the size and character of investments;
- the size of fixed assets;
- the size and nature of investments in subsidiaries and other affiliates and the extent to which the bank will support those entities in times of difficulty;
- the source and nature of deposits and their volatility;
- the nature and extent of other liabilities and contingent liabilities, including standby facilities;
- the earnings and dividend record and the adequacy of capital;
- the activities of the bank in the foreign-exchange and interbank markets;
- the size and character of the bank's international business; and
- the competency of management.

The quality of management is the key to the analysis of foreign banks and is best determined by frequent visits by officers of the lending bank. Credit checks from other lenders should be required with periodic updates. Credit reports are not available in all countries and, when provided, are often incomplete or vague. Consequently, there is no substitute for firsthand information obtained from visits to overseas banks.

*Country risk.* Balance of payments; exchange control; and economic, political, and social information on each borrower's home country should be on file to enable the bank to assess the elements of country risk. The lack of this information is as serious a weakness as the lack of financial information on the borrowers. For additional information, see section 7040, "International—Transfer Risk."

*Limits and guidelines for purchasing loans.* Purchasing loans from dealers or correspondent banks is a common practice in banks with limited opportunities to generate international credit extensions on their own. However, these purchases may restrict a bank to low-profit loans at narrow spreads over a medium-to long-term period. Buying loans seldom builds relationships with borrowers since the relationship generally stays with the bank originating the loan. Therefore, the lending policy should limit the amount of paper purchased from any one outside source and should state an aggregate limit on all these loans.

*Limitation on aggregate outstanding loans.* Limitations on the total amount of loans outstanding relative to other balance-sheet accounts should be established for the bank, with limits (or sublimits) applicable to international loans clearly defined. Controls over the international loan portfolio are usually expressed relative to deposits, capital structure, or total assets.

*Concentration of credits.* The same types of concentrations of credits found in a domestic loan portfolio may exist in the international portfolio. In international banking, however, an additional concentration involves loans to a foreign government, its agencies, and its majority-owned or -controlled entities. Loans to specific private businesses may be included in those concentrations if an interrelationship exists in the form of guarantees, moral commitments,

significant subsidies, or other factors indicating dependence on the government. The bank's directorate should evaluate the risks involved in various concentrations and determine those concentrations that should be avoided or limited. The lending policy should also require that all concentrations in the international division be reviewed and reported frequently. For a full discussion of this component, see section 2050, "Concentrations of Credits."

*Loan authority.* The lending policy should establish written limits for all international lending officers. Lending limits also may be established for group authority, allowing a combination of officers or a committee to approve loans larger than those the members would be permitted to approve individually. The reporting procedures and the frequency of committee meetings should be defined. If the bank operates foreign branches, head office–delegated lending authority should be clearly defined and understood by overseas lending officers.

*Nonperforming credits and charge-offs.* The lending policy should define nonperforming credit extensions of all types (delinquencies, nonaccruals, or reduced rates) and should specify their accounting and reporting requirements. Reports should be submitted regularly to the board of directors and senior management. The management of banks with overseas branches must take extra care to define and communicate their banks' policies and procedures on nonperforming credits to ensure that all bank offices are properly identifying, accounting for, and reporting credits. The reports should include sufficient detail to allow for the determination of risk factors, loss potentials, and alternative courses of action to effect repayment of nonperforming credits. The policy governing delinquent credits should require a follow-up notice procedure that

is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by senior management or the directorate for potential charge-off at a stated period of delinquency.

*Other.* The lending policy should be supplemented with other written guidelines for specific departments concerned with credit extensions, such as letters of credit, banker's acceptances, and discounted trade bills. Written policies and procedures approved and enforced in those departments should be referenced in the general lending policy of the bank.

Before a bank grants international credit, its objectives, policies, and practices must be clearly established. The bank must consider its overall size, financial resources, the nature of its customers, its geographic location, and the qualifications and skills of its staff. An examiner should review policies and practices to determine if they are clearly defined and adequate to monitor the condition of the portfolio. If written guidelines do not exist, there is a major deficiency in the lending area, and the board of directors is not properly discharging its duties and responsibilities. If no exception is taken to the objectives, policies, and practices, the international loan portfolio can then be reviewed to ensure compliance.

The failure of the directors to establish a sound international lending policy, of the management to establish adequate written procedures, or of both to monitor and administer the international lending function within established guidelines has resulted in serious problems for banks. Major sources and causes of loan trouble, as discussed in domestic "Loan Portfolio Management," section 2040, also apply to international lending.

# International—Loan Portfolio Management

## Examination Objectives

Effective date May 1996

## Section 7020.2

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1. To determine if policies, practices, procedures, and internal controls for international loan portfolio management are adequate.
2. To determine if bank officers are operating in conformance with the established bank guidelines.
3. To determine the scope and adequacy of the audit function as it relates to international lending procedures.
4. To determine the overall quality of the international loan portfolio and how that quality affects the soundness of the bank.
5. To prepare information on the bank's lending function in a concise, reportable format.
6. To determine compliance with applicable laws and regulations.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

# International—Loan Portfolio Management

## Examination Procedures

Effective date March 1984

## Section 7020.3

1. If selected for implementation, complete or update the International Loan Portfolio Management section of the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examining procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
3. Request reports on the following from the bank's international division, by department, as of the examination date unless otherwise specified:
  - a. Past-due loans. This report should cover:
    - Single payment and demand notes past due.
    - Single payment and demand notes on which interest is due and unpaid for 30 days or more.
    - Consumer, mortgage and term loans payable in regular installments on which one installment is due and unpaid for 30 days or more.
    - Outstandings under cancelled advance (overdraft) facilities that are unpaid.
    - Discounted (purchased) outgoing foreign bills matured and unpaid and advances secured by pledged delinquent foreign bills.
    - Unauthorized overdrafts including any resulting from customers not paying the bank for banker's acceptances or drafts it paid.And should include the following information:
    - Name of the obligor.
    - Original amount of the loan.
    - Outstanding balance of the loan.
    - Date the loan was made.
    - Due date.
    - Terms of the loan.
    - Number of payments the loan is delinquent.
    - Date of the borrower's last payment.
    - Date to which interest is paid.For larger international loans, the report should also include:
    - Purpose of the loan.
    - Any action being taken to bring the loan current.
  - b. International loans on which interest is not being collected in accordance with the terms of the loan.
  - c. International loans the terms of which have been modified by a reduction of interest rate or principal payment or by a deferral of interest or principal.
  - d. International loans for which repayment terms have been restructured.
  - e. International loan participations purchased and sold and participations in consortium credits since the previous examination.
  - f. International loans sold in full since the previous examination.
  - g. International credits considered "problem credits" by management (this report may be either as of the examination date or as of the date the report was last submitted to the officer's loan review committee(s), the loan and discount committee(s), or the board of directors).
  - h. International credit commitments and other contingent liabilities.
  - i. Loans secured by stock of other banks and rights, interest, or powers of a savings and loan association.
  - j. Extensions of credit to employees, officers, directors, or their interests.
  - k. Extensions of credit to executive officers, directors, principal shareholders and their interests of correspondent banks.
  - l. Miscellaneous loan debit and credit suspense accounts.
  - m. Current interest rate structure.
  - n. Current lending authorities of officers and credit committee(s).
4. Obtain the following information:
  - a. A copy of written policies covering all international lending functions.
  - b. A statement of whether a standing committee administers the lending function.
  - c. Copies of reports furnished to the board of directors for its meetings.
  - d. Lists of directors, executive officers, principal shareholders and their interests.
  - e. A summary of the officer borrowing report (debts to own and other banks).

- f. A list of previously charged-off loans approved by the directors.
5. Obtain a copy of the latest reports furnished to the international loan and discount committee(s). (The domestic loan and discount committee(s) sometimes handle(s) international loans and discounts.)
6. Review international lending policies and updates and abstract appropriate excerpts on:
  - a. Distribution of loans by category.
  - b. Geographic area and country exposure limitations.
  - c. Type of borrowing and industrial concentration limitations.
  - d. Lending authorities of committees and officers.
  - e. Any prohibited types of international loans.
  - f. Maximum maturities for various types of international loans.
  - g. Interest rate structure.
  - h. Minimum downpayment for various types of loans.
  - i. Collateral appraisal policies including:
    - Persons authorized to perform appraisals.
    - Lending values of various types of assets.
  - j. Financial information requirements by types of loans.
  - k. Guidelines for purchasing other banker's acceptances and commercial paper.
    1. Guidelines for loans to major shareholders, directors, officers, or their interests.
7. When more than one international lending policy exists, determine if they are internally consistent by reviewing the guidelines previously obtained.
8. Review minutes of the bank's international loan and discount committee(s) meetings to obtain:
  - a. Present members and their attendance record.
  - b. Scope of work performed.
  - c. Any information considered useful in the examination of specific loan categories or other areas of the bank.
9. Compare reports furnished to the board of directors and the loan and discount committee(s), and those received from the bank in step 3 to determine any material differences and that the differences are transmitted to the board in a timely manner.
10. Compare the lists of directors, officers and their related interests to determine:
  - a. Preliminary compliance with Regulation O (12 CFR 215) (loans to insiders).
  - b. Preliminary compliance with established policies.
11. Perform the following steps for past-due loans:
  - a. Compare the following to determine any material inconsistencies:
    - The past-due schedule received in step 3. Delinquency reports submitted to the board.
    - List of loans considered "problem" loans by management.
  - b. Scan the delinquency lists submitted to the board of directors and senior management to determine that reports are sufficiently detailed to evaluate risk factors.
  - c. Compile current aggregate totals of past-due paper.
12. Perform the following using the loan commitments and contingent schedules obtained in step 3:
  - a. Reconcile appropriate contingency totals to memoranda ledger controls.
  - b. Review reconciling items for reasonableness.
13. Obtain the listing of Uniform Review of Shared National Credits and update the listing based on information obtained in step 3.
14. Obtain the classifications and categories of strong, moderately strong, and weak countries from Interagency Country Exposure Review Committee meeting for which write-ups have been made available and update that data based on information obtained in step 3.
15. Distribute the applicable schedules and other information obtained in the preceding steps to the examiners performing the loan examination programs. Request that the examiners test the accuracy of the information. Also, request that they perform appropriate steps in the separate program "Concentration of Credits."
16. Determine the general distribution and characteristics of the international loan portfolio by:
  - a. Determining the percentage of total loans in specific classes and geographic areas.
  - b. Comparing international loan category distributions to policy guidelines.



17. Obtain the results of the reviews performed of the various segments of the international division during the course of the examination, and perform the following:
  - a. Determine any nonadherence to internally established policies, practices, procedures, and controls.
  - b. Compare the various international division results to determine the extent of nonadherence and if it is systemwide.
  - c. Organize internal guideline exceptions in order of relative importance.
  - d. Determine the aggregate amount of statutory bad debts.
  - e. Organize violations by law and regulation.
  - f. Review international credit classifications and assets listed for special mention to determine:
    - Inclusion of all necessary information.
    - Substantiation of classification or criticism.
  - g. Determine the aggregate amount of credit extensions listed in each of the four levels of criticism.
  - h. Compile a listing of all credit extensions not supported by current and satisfactory credit information.
  - i. Compile a listing of all credit extensions not supported by complete collateral documentation.
  - j. Review the separate procedures for “Concentration of Credits” and determine:
    - If all necessary data is included.
    - If there is substantiation for including specific items in the report of examination as a concentration.
    - If the concentration is undue or unwarranted.
  - k. Compute the following ratios and compare to computations from prior examinations:
    - Aggregate international division past due paper to international division loans and overdrafts outstanding.
    - Aggregate international division “A” paper to international division past due.
    - Total international division past due, nonaccrual and renegotiated rate credits to total international division credits.
    - Aggregate classified international credits to primary capital funds.
    - Aggregate classified international credit to total bank classified credits.
    - Weighted classified international credits to primary capital funds.
18. Forward the totals of international division loss and doubtful classifications to the examiner assigned to analyze the adequacy of the bank’s capital.
19. Compare management’s list of “problem” credits from step 3 to the examiner’s listing of international classified and criticized credits to determine the extent of management’s knowledge of its own international credit problems.
20. Determine, through an in-depth analysis of information previously generated, the causes of existing problems or weaknesses within the international division’s systems which present potential for future problems.
21. Forward the following information to the examiner assigned to analyze the bank’s loan loss reserves.
  - a. A listing of international division credits considered “problem” credits by management.
  - b. A listing of classified and criticized credits relating to the international division.
  - c. A listing of previously charged-off loans.
22. Organize the results of the examination of the international lending function to facilitate discussion with the examiner-in-charge and, upon approval, with senior management of the bank.
23. During discussion with senior management, structure inquiries in such a manner as to:
  - a. Gain insight into management’s international lending philosophy.
  - b. Elicit management responses for correction of deficiencies.
24. Write, in appropriate report format, general remarks which may include:
  - a. The scope of the examination of the international lending function.
  - b. The quality of internal policies, practices, procedures, and controls over the international lending function.
  - c. The general level of adherence to internal policies, practices, procedures, and controls that govern the bank’s international lending function.
  - d. The scope and adequacy of the internal loan review system regarding international credit extensions.
  - e. The quality of the entire international credit portfolio.

- f. The competency of management with respect to the international lending function.
  - g. Causes of existing credit problems.
  - h. Expectations for continued sound international lending and correction of existing credit control and quality deficiencies.
  - i. Promises made by management for correction of credit control and quality deficiencies.
  - j. Credit extensions to insiders and their interests.
25. Compile or prepare all information which provides substantiation for your general remarks.
  26. Update the workpapers with any information that will facilitate future examinations.

# International—Loan Portfolio Management

## Internal Control Questionnaire

Effective date June 1985

## Section 7020.4

Review the bank's internal controls, policies, practices, and procedures for managing the bank's loan portfolio. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

1. Has the board of directors, consistent with its duties and responsibilities, adopted written international loan portfolio management objectives and policies that:
  - a. Establish suggested guidelines for distribution of international loans by different categories?
  - b. Establish geographic area limits for credits?
  - c. Establish suggested guidelines for aggregate outstanding international loans in relation to other balance sheet categories?
  - d. Establish international loan authority of committees and individual lending officers?
  - e. Define acceptable types of international loans?
  - f. Establish maximum maturities for various types of international loans?
  - g. Establish international loan pricing?
  - h. Establish appraisal policy?
  - i. Establish minimum financial information required at inception of the credits?
  - j. Establish limits and guidelines for purchasing paper?
  - k. Establish guidelines for loans to bank directors, officers, and their related interests?
    1. Establish collection procedures?
  - m. Define the duties and responsibilities of international loan officers and loan committees?
  - n. Outline international loan portfolio management objectives that acknowledge:
    - Concentrations of credit within specific industries and relating to country credits?
    - The need to employ personnel with specialized knowledge and experience?
    - Possible conflicts of interest?
2. Are international loan portfolio management objectives and policies reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are the following reported to the board of directors or its designated committees (indicate which) at their regular meetings (at least monthly):
  - a. Past-due single payment loans (if so, indicate the minimum days past due for them to be included \_\_\_\_\_)?
  - b. Loans on which interest only is past due (if so, indicate the minimum days past due for them to be included \_\_\_\_\_)?
  - c. Term loans on which one installment is past due (if so, indicate the minimum days past due for them to be included \_\_\_\_\_)?
  - d. Outstandings under overdraft facilities that are unpaid (if so, indicate the minimum days past due for them to be included \_\_\_\_\_)?
  - e. Discounted (purchased) outgoing foreign bills matured and unpaid (or advances collateralized by pledged delinquent foreign bills) (if so, indicate the minimum days past due for them to be included \_\_\_\_\_)?
  - f. Overdrafts resulting from a customer not paying the bank for banker's acceptances or drafts the bank paid (if so, indicate minimum days past due for them to be included \_\_\_\_\_)?
  - g. Total outstanding international loan commitments?
  - h. Loans requiring special attention?
  - i. New loans and loan renewals or restructured loans?
4. Are reports submitted to the board or its committees rechecked by a designated person for possible omissions prior to their submission?
5. Are written applications required for all international loans?
6. Does the bank maintain credit files for all international borrowers?
7. Does the credit file contain information on:
  - a. The purpose of the loan?
  - b. The planned repayment schedule?
  - c. The disposition of loan proceeds?

- d. The points to be raised regarding the borrower from which to base questions during officer calling programs?
- e. Lending officer calls on customers and foreign countries?
8. Does the bank require periodic submission of financial statements by all international division borrowers whose loans are not fully secured by readily marketable collateral?
9. Is a tickler file maintained to assure that current financial information is requested and received?
10. Does the bank require submission of certified financial statements based on dollar amount of commitment (if so, state the dollar or equivalent minimum \$\_\_\_\_\_)?
11. Are financial statements of foreign borrowers spread in the credit file by local currency and U.S. dollar equivalents, if appropriate, on a yearly comparative basis?
12. Are borrower financial statements spread with those of comparable borrowers in the same country?
13. Does the bank perform a credit investigation on proposed and existing borrowers for new loan applications?
14. Does the bank have a periodic lending officer call program for:
  - a. Customers?
  - b. Countries?
15. Is it required that all international loan commitments be in writing?
16. Are international lines of credit reviewed and updated at least annually?
17. Are borrower's outstanding liabilities checked to appropriate lines of credit prior to granting additional advances?
18. Is there an internal review system (it may be a function of the internal audit department) which covers each department and:
  - a. Rechecks interest, discounts, fees, commissions, and maturity date computations?
  - b. Re-examines debt instruments for proper execution, receipt of all required supporting papers, and proper disclosure forms?
  - c. Determines that international loan approvals are within the limits of the bank's lending authorities?
  - d. Determines that international loans outstanding and committed are within the bank's foreign country or foreign currency limits?
- e. Determines that notes and debt instruments are being approved initially by the loan officer?
- f. Ascertains that new international loans are within the limitations set for the borrower by corporate resolution?
- g. Rechecks liability ledgers to determine that new loans have been accurately posted?
- h. Rechecks the preparation of maturity and interest notices?
- i. Examines entries to various general ledger loan controls?
- j. Confirms collateral, loans, and discounts with customers on a test basis?
19. Does the bank have an international loan review section or the equivalent?
20. Is the loan review section independent of the international lending function?
21. Are the initial results of the international loan review process submitted to a person or committee which is also independent of the international lending function?
22. Are all international loans exceeding a certain dollar amount selected for review?
23. Do international lending officers recommend loans for review?
24. Is a method, other than those detailed in steps 23 or 24, used to select international loans for review (if so, provide details)?
25. Are internal reviews conducted at least annually for all international lending areas?
26. In an officer identification system, are guidelines in effect which define the consequences of an officer withholding a loan from the review process?
27. Is the bank's international problem loan list periodically updated by the lending officers?
28. Does the bank maintain a list of international loans reviewed, indicating the date of the review and the credit rating?
29. Does the loan review section prepare summaries to substantiate credit ratings, including pass loans?
30. Are loan review summaries maintained in a central location or in appropriate credit files?
31. Are followup procedures in effect for internally classified international loans, including an update memorandum to the appropriate credit file?
32. Are officers and employees prohibited from holding blank signed notes and other debt

- instruments in anticipation of future borrowings?
33. Are paid and renewed notes cancelled and promptly returned to customers?
  34. Do loan proceeds disbursed in cash require a customer receipt?
  35. Are international loan records retained in accordance with record retention policy and legal requirements?
  36. Are new notes microfilmed daily?
  37. Is a systematic and progressively stronger follow-up notice procedure utilized for delinquent loans?
  38. Does the bank maintain loan interest, discount, fee, and commission rate schedules for various types of international loans?
  39. Does the bank periodically update the above rate schedules (if so, state normal frequency \_\_\_\_\_)?
  40. Does the bank maintain records in sufficient detail to generate the following information by type of advance:
    - a. The cost of funds loaned?
    - b. The cost of servicing loans, including overhead?
    - c. The cost factor of probable losses?
    - d. The programmed profit margin?
  41. Does the international division maintain adequate and current country analysis information?
  42. Has the international division conducted studies for those industries in which it is a substantial lender?

## CONCLUSION

43. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
44. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

# International—Loans and Current Account Advances

Effective date May 1996

## Section 7030.1

A bank's international division lends, either directly or through state entities, to U.S. importers and exporters, foreign companies, multinational corporations, foreign banks, and foreign governments. The terms of these lending activities are consistent with the purpose of the financing.

Short-term working-capital loans to commercial business enterprises commonly finance inventories or receivables arising from trade. Receivable pledges, warehouse receipts, and liens on inventory or commodities may be held as collateral. However, in certain countries, these forms of collateral are not legally recognized and, therefore, the banks must be thoroughly familiar with applicable local laws, regulations, and practices. Loans to foreign banks are usually short-term and unsecured.

Medium-term lending (one to five years) generally represents capital goods financing, shipping loans, and various specialized credits. Long-term loans (those exceeding five years) are normally used to finance extensive projects of multinational corporations, foreign governments, or foreign state entities. Government guarantees of private long-term loans are common when the project has significant importance to a national economy.

The methods of loan financing in an international division are the same as those for domestic lending. Loans in the international division may be direct or discounted. In both of these instances, the bank holds a promissory note or similar instrument evidencing indebtedness. Current account advances, however, are a category of loans unique to international banking. This method of financing is an American substitute, used by banks in the United States, for the European method of financing by overdrafts, which is also a common lending method of overseas offices of U.S. banks. Current account advances, like overdrafts, are extensions of credit in which no instrument of specific indebtedness is used; however, a signed agreement is on file stating the conditions applicable to advances made by the bank to the obligor. Other types of

international financing treated as loans include own acceptances purchased (discounted), other banker's acceptances purchased, and discounted trade acceptances.

The same credit risks apply to international division loans as to those made in domestic loan departments, with the addition of country risk, which is the primary additional component that distinguishes an international loan from a domestic loan. Country risk encompasses the entire spectrum of risks arising from the economic, social, and political environments of a foreign country and from the governmental policies structured to respond to those conditions that may have adverse consequences for the repayment of a foreign borrower's debt. More specifically, there is a risk associated with a borrower's capacity to obtain the foreign exchange required to service its cross-border debt (that is, transfer risk). An obligor may have the financial means in its domestic currency to repay its indebtedness, but nationalization, expropriation, governmental repudiation of external indebtedness, the imposition of exchange controls, or currency devaluation may preclude the lender from obtaining timely repayment. Apart from a nation's outright repudiation of external debt, these developments might not result in an uncollectible extension of credit; however, the delay in collection could adversely affect the condition of the lending bank.

This section is designed to apply to most types of loans and current account advances found in an international division. However, lending areas in many international divisions and overseas branches are often segregated into separate departments and differ substantially from international loans and current account advances. Those are discussed in separate sections of this manual: "International—Financing Foreign Receivables," "International—Banker's Acceptances," "International—Letters of Credit," and "International—Guarantees Issued," sections 7050, 7060, 7080, and 7090, respectively.

# International—Loans and Current Account Advances

## Examination Objectives

Effective date May 1996

Section 7030.2

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1. To determine the adequacy of policies, practices, procedures, and internal controls for international loans and advances.
2. To determine if bank officers are operating in conformance with established bank guidelines.
3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it relates to international lending procedures.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

# International—Loans and Current Account Advances Examination Procedures

Effective date October 2008

Section 7030.3

1. If selected for implementation, complete or update the international lending section of the internal control questionnaire.
2. Determine the scope of the examination on the basis of the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest reviews done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records.
  - a. Reconcile balances to department controls and the general ledger.
  - b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination, review the loan and collateral documentation, and prepare credit line cards.
6. Obtain the following information:
  - a. past-due, nonaccrual, and reduced-rate loans and advances
  - b. loans whose terms have been modified by a reduction in interest rate or principal payment or by a deferral of interest or principal
  - c. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination.
  - d. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
  - e. loan commitments and other contingent liabilities
  - f. reports of the indebtedness of executive officers, principal shareholders, and their related interests to correspondent banks
  - g. a list of correspondent banks
  - h. extensions of credit to major stockholders of the bank and to bank employees, officers, and directors, and to their related interests (specify which officers are considered executive officers)
7. Review the information received and perform the following procedures.
  - a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.*
    - Participations only:
      - Test participation certificates and records, and determine that the parties share in the risks and contractual payments on a pro rata basis.
      - Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
      - Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
    - All transfers:
      - Investigate any situations in which loans were transferred immediately
  - i. miscellaneous loan-debit and credit-suspense accounts
  - j. Interagency Country Exposure Review Committee (ICERC) determinations
  - k. criticized Shared National Credits (applicable international division credits)
  - l. loans considered “problem loans” by management
  - m. specific guidelines in the lending policy
  - n. current lending authorities of bank officers and credit committees
  - o. the current interest-rate lending structure of the bank
  - p. any useful information on international division credit extensions resulting from the review of the minutes of the loan and discount committee(s) and any other credit committee(s)
  - q. reports on international division credit extensions furnished to the loan and discount committee(s) and any other credit committee(s)
  - r. relevant reports furnished to the board of directors
  - s. loans criticized during the previous examination



- before the date of examination to determine if any were transferred to avoid possible criticism during the examination.
- Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
  - Determine that the consideration received for low-quality loans transferred from the bank to an affiliate is properly reflected on the bank's books and is equal to the fair market value of the transferred loans (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium). Section 23A of the Federal Reserve Act generally prohibits a state member bank from purchasing a low-quality asset.
  - Determine that low-quality assets transferred to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.
  - If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
    - (1) name of originating institution
    - (2) name of receiving institution
    - (3) type of transfer (i.e., participation, purchase or sale, swap)
    - (4) date of transfer
    - (5) total number of loans transferred
    - (6) total dollar amount of loans transferred
    - (7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
    - (8) any other information that would be helpful to the other regulator
- b. *Miscellaneous loan-debit and credit-suspense accounts.*
    - Discuss with management any large or old items.
    - Perform additional procedures as considered appropriate.
  - c. *Loan commitments and other contingent liabilities.* Analyze the commitment or contingent liability together with the combined amounts of the current loan balance, if any.
  - d. *Loans criticized during the previous examination.* Determine disposition of loans so criticized by transcribing the current balance and payment status or the date the loan was repaid and the source of repayment.
    - Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank or as a result of a participation, sale, or swap with another lending institution.
    - If repayment was a result of a participation, sale, or swap, refer to step 7a of this section for the appropriate examination procedures.
  - e. *Shared National Credits.*
    - Compare the schedule of international loans and current account advances included in the Uniform Review of National Credits program with the bank's reports of international loans outstanding.
    - For each loan or advance so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these credits.
  - f. *ICERC credits.*
    - Identify any loans that were selected for review that are criticized for transfer-risk reasons by ICERC.
    - For each loan or advance so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these credits.
8. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.
  9. Prepare credit line cards for any international loan not previously selected for review that, on the basis of information derived

- from the above schedules, requires an in-depth review.
10. Obtain customer liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and other lending areas, and together decide who will review the borrowing relationship. Pass or retain complete credit line cards.
  11. Prepare collateral line cards for all borrowers selected in the preceding steps.
  12. Obtain credit files for all borrowers for whom examiner credit line cards were prepared, and complete the credit line cards, where appropriate. To analyze the international loans, perform the following procedures:
    - a. Analyze balance sheets and profit-and-loss figures as shown in current and preceding financial statements, and determine the existence of any favorable or adverse trends or ratios.
    - b. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure of the borrower.
    - c. Review supporting information for the major balance-sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate the adequacy of those sources.
    - d. Ascertain compliance with provisions of credit agreements.
    - e. Review digests of officers' memoranda, mercantile reports, credit checks, and correspondence to determine the existence of any problems that might deter the contractual repayment programs of the borrower's indebtedness.
    - f. Relate collateral values to outstanding debt, and determine when the collateral was last appraised.
    - g. Compare interest rates charged with the current interest-rate schedule of the bank, and determine that the terms are within established guidelines.
    - h. Compare the original amounts of the customer's obligations to the bank with the lending officer's authority.
    - i. Analyze secondary support afforded by guarantors and endorsers.
    - j. Ascertain compliance with the bank's established international loan policy.
  13. For loans selected for review, check the central liability file for borrowers indebted above the cutoff line or for borrowers displaying credit weakness or suspected of having additional liability in other lending areas.
  14. Transcribe significant liability and other information on officers, principals, and affiliations of borrowers selected for review. Cross-reference line cards to borrowers, where appropriate.
  15. Determine the bank's compliance with laws and regulations pertaining to international lending by performing the following steps:
    - a. *Lending limits.*
      - Determine the bank's lending limit as prescribed by state law.
      - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    - b. *Section 23A, Relations with Affiliates (12 USC 371c), and section 23B, Restrictions on Transactions with Affiliates (12 USC 371c-1), of the Federal Reserve Act, and the Board's Regulation W.*
      - Obtain a listing of loans to affiliates.
      - Test-check the listing against the bank's customer liability records to determine its accuracy and completeness.
      - Ensure that loans to affiliates do not exceed limits of section 23A and Regulation W.
      - Ensure that loans to affiliates meet the collateral requirements of section 23A and Regulation W.
      - Determine that low-quality assets have not been purchased from an affiliate.
      - Determine that all covered transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
      - Determine that all transactions with affiliates comply with the market-terms requirement of section 23B and Regulation W.
    - c. *18 USC 215, Receipt of Commission or Gift for Procuring Loans.*
      - While examining the international lending function, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.

- Investigate any such suspected instances.
- d. *Federal Election Campaign Act (2 USC 441b), Political Contributions and Loans.*
- While examining the international lending area, determine the existence of any loans in connection with any political campaigns.
  - Review each such credit to determine whether it is made in accordance with applicable banking laws and in the ordinary course of business.
- e. *Regulation Y (12 CFR 225.7), Tie-In Provisions.* While reviewing international credit and collateral files, especially loan agreements, determine whether any extension of credit is conditioned upon—
- obtaining or providing any additional credit, property, or service from or to the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service, or
  - the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit.
- f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows: (The examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment.)
- *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests.* While reviewing information relating to insiders received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps)—
    - test the accuracy and completeness of information about international loans by comparing it with the trial balance or loans sampled;
    - review credit files on insider loans to determine that required information is available;
    - determine that loans to insiders do not contain terms more favorable than those afforded other borrowers;
    - determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features;
    - determine that loans to insiders do not exceed the lending limits imposed by Regulation O;
    - if prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained;
    - determine compliance with the various reporting requirements for insider loans;
    - determine that the bank has made provisions to comply with the disclosure requirements for insider loans; and
    - determine that the bank maintains records of public disclosure requests and the disposition of the requests for a period of two years after the dates of the requests.
  - *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (P.L. 95-630), as amended by the Garn-St Germain Depository Institutions Act of 1982, Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
    - Obtain from, or request that the examiners reviewing due from banks and deposit accounts verify, a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
    - Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.
- g. *12 USC 1828(v), Loans Secured by Bank Stock.*
- While examining international loans, determine the existence of any loans or discounts that are secured by the insured financial institution's own stock.
  - In each such case, determine that the chief executive officer has promptly

- reported such fact to the proper regulatory authority.
- h. *12 USC 83 (Rev. Stat. 5201), made applicable to state member banks by section 9, paragraph 6, of the Federal Reserve Act (12 USC 324), Loans Secured by Own Stock (see also Federal Reserve Regulatory Service 3–1505):*
- While examining international loans, determine the existence of any loans secured by the bank's own shares or capital notes and debentures.
  - Confer with the examiner assigned investment securities to determine whether the bank owns any of its own shares or its own notes and debentures.
  - In each case in which such collateral or ownership exists, determine whether the collateral or ownership was taken to prevent a loss on a debt previously contracted (DPC) transaction.
  - In each case of ownership, determine whether the shares or subordinated notes and debentures have been held for a period of not more than six months.
- i. *Regulation U (12 CFR 221).* While reviewing credit files, check the following for all loans that are secured directly or indirectly by margin stock and that were extended for the purpose of buying or carrying margin stock:
- Except for credits specifically exempted under Regulation U, determine that the required Form FR U-1 has been executed for each credit by the customer and that it has been signed and accepted by a duly authorized officer of the bank acting in good faith.
  - Determine that the bank has not extended more than the maximum loan value of the collateral securing such credits, as set by section 221.7 of Regulation U, and that the margin requirements are being maintained.
  - Determine compliance with other specific exceptions and restrictions of the regulation as they relate to the credits reviewed.
- j. *Regulation K (12 CFR 211) and Regulation Y (12 CFR 225), International Banking Operations.*
- Review all applicable sections, especially those concerned with—
    - loans or extensions of credit to foreign banks,
    - loans to executive officers of foreign branches of state member banks,
    - a statement of policy or the availability of information to facilitate supervision of foreign operations, and
    - reporting and disclosure of international assets and accounting for fees on international loans.
- k. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103), Retention of Credit Files.* Review the operating procedures and credit file documentation, and determine if the bank retains records of each extension of credit over \$10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date thereof. (See 31 CFR 103.33.) (Loans secured by an interest in real property are exempt.)
- l. *Export-Import Bank of the United States.* Review extensions of credit to determine compliance with Eximbank's lending standards, policies, guidelines, and regulations as they relate to direct lending programs, cooperative financing facilities, private export funding, exporter credit programs, medium-term export debt obligations, leasing, loan guarantees, export credit insurance, and discount programs.
- m. *7 CFR 1400–1499, Commodity Credit Corporation.* Determine the compliance of international loans relating to Commodity Credit Corporation programs.
- n. *22 CFR 200–299, Agency for International Development.* Review to determine the compliance of international loans related to Agency for International Development programs.
- o. *Section 909, International Lending Supervision Act (12 USC 3908).* Section 909 of the International Lending Supervision Act of 1983 (the act) requires that FDIC-insured banks and Edge and agreement corporations prepare a written economic feasibility evaluation signed by a senior official of the banking institution for any proposed extension of credit by the lead U.S. banking institution or insti-

tutions, which individually or when aggregated with credits of other U.S. banking institutions exceeds \$20 million per project, to finance the construction or operation of any mining operation, any metal or mineral primary processing operation, any metal fabricating facility or operation, or any metal-making (semi- and finished) operation located outside the United States or its territories or possessions. The act stipulates that the evaluation shall consider the profit potential, the competitive and economic impact of the project, and the reasonable expectation of repayment. The act also mandates that any new evaluations be reviewed by federal examiners in the context of every examination. The following checklist should be used to test compliance with the requirements of the act:

- Does the banking institution have a written economic feasibility evaluation for all credit extensions by that banking institution alone or in conjunction with other U.S. banking institutions, which individually or when aggregated with credits of other U.S. banking institutions exceed \$20 million per project, to finance any of the designated projects?
- Is the evaluation signed by a senior officer of the examined or the lead U.S. banking institution?
- Does the evaluation consider the following:
  - profit potential of the project
  - impact of the project on world markets
  - inherent competitive advantages and disadvantages of the project over the entire life of the project
  - the likely effect of the project on the overall long-term economic development of the country in which it is located
  - the reasonable expectation of repayment from revenues generated by the project, without regard to any subsidy provided by the government involved or any instrumentality of any country

Although the bank's evaluation should be done in a professional manner, examiners need

not verify its accuracy. However, any negative responses to the foregoing questions would be indicative of noncompliance with the statute and should be discussed with the appropriate level of bank management. Any apparent violations should be cited in the examination report, along with a discussion of any remedial actions taken by bank management during the examination.

16. Perform the appropriate steps in "Concentrations of Credit," section 2050.3.
17. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
  - a. delinquent loans;
  - b. violations of laws and regulations;
  - c. loans not supported by current and complete financial information;
  - d. loans on which collateral documentation is deficient;
  - e. concentrations of credit;
  - f. criticized loans;
  - g. inadequately collateralized loans;
  - h. extensions of credit to major shareholders, employees, officers, directors, and their related interests;
  - i. loans whose ultimate collection is questionable for any other reason; and
  - j. other matters regarding the condition of the department.
18. Provide details of classified international participation loans that are not covered by the Shared National Credit Program. Include the names and addresses of all participating state member banks and copies of the criticized loan comments.
19. Provide the examiner-in-charge with your findings on—
  - a. the adequacy of written policies relating to international loans;
  - b. the manner in which bank officers are operating in conformance with established policy;
  - c. adverse trends within the international lending function;
  - d. the accuracy and completeness of the schedules obtained from "International—Loan Portfolio Management," section 7020.3.
  - e. internal control deficiencies or exceptions;
  - f. recommended corrective action when policies, practices, or procedures are deficient;
  - g. the competency of management of the

- international lending function; and
  - h. other matters of significance.
20. Update the workpapers with any information that will facilitate future examinations.

# International—Loans and Current Account Advances

## Internal Control Questionnaire

Effective date March 1984

Section 7030.4

Review the bank's internal controls, policies, practices, and procedures for granting and servicing international loans. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written international loan policies that:
  - a. Establish procedures for reviewing international loan applications?
  - b. Define qualified borrowers?
  - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are international loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

- \*3. Is the preparation and posting of subsidiary international loan records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
- \*4. Are the subsidiary international loan records (control totals) balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle loans and post records?
5. Are the following properly recorded as "loans" for accounting and call report purposes:
  - a. Acceptances of other banks purchased?
  - b. Own acceptances purchased (discounted)?
  - c. Customer's liability to the bank on drafts paid under letters of credit for which the bank has not been reimbursed?

- \*6. Is a loan delinquency report prepared for and reviewed by management frequently (if so, how often \_\_\_\_\_)?
- \*7. Are inquiries about loan balances received and investigated by persons who do not process loans, handle settlements, or post records?
- \*8. Are bookkeeping adjustments checked and approved by an appropriate officer?
  9. Is a daily record maintained summarizing loan transaction details, i.e., loans granted, payments received, and interest collected, to support applicable general ledger account entries?
10. Are frequent note (or record copy) and liability trial balances prepared and reconciled monthly with control accounts by employees who do not process or record loan transactions?

### INTEREST

- \*11. Is the preparation and posting of interest records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
12. Are any independent interest computations made and compared or adequately tested to initial interest records by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?

### COLLATERAL

13. Are multicopy, pre-numbered records maintained that detail the complete description of collateral pledged?
14. Are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?
15. Is negotiable collateral held under joint custody?
16. Are receipts obtained and filed for released collateral?
17. Are securities valued and margin requirements reviewed at least monthly?

18. When collateral support is the cash surrender value of insurance policies, is a periodic accounting received from the insurance company and maintained with the policy?
19. Is a record maintained of entry to the collateral vault?
20. Are stock powers filed separately to bar negotiability and to deter abstraction of both the security and the negotiating instrument?
21. Are securities out for transfer, exchange, etc., controlled by pre-numbered temporary vault-out tickets?
22. Are pledged deposit accounts properly coded to negate unauthorized withdrawal of funds?
23. Are acknowledgements received for pledged deposits held at other banks?
24. Is an officer's approval necessary before collateral can be released or substituted?
  - c. Determines that items released on temporary vault-out tickets are authorized and have not been outstanding for an unreasonable length of time?
  - d. Determines that loan payments are promptly posted?
28. Are all notes and advances recorded on a register or similar record and assigned consecutive numbers?
29. Are payment notices prepared and sent by someone not connected with loan processing?
30. Are any notes signed by a customer in blank and held in anticipation of future borrowings properly safeguarded?
31. Are lending officers frequently informed of maturing loans and credit lines?

## OTHER

25. Are notes and advance slips safeguarded during bank hours and locked in the vault overnight?
26. Are all loan rebates approved by an officer and made only by official check?
27. Does the bank have an internal review system that:
  - a. Re-examines collateral items and supporting documentation for negotiability and proper assignment?
  - b. Test checks values assigned to collat-

## CONCLUSION

32. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
33. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).



When banks engage in international lending, they undertake customary credit risk as denoted by the possibility of nonpayment because of an obligor's weak financial condition or a lack of adequate collateral protection. International lending also bears risks associated with conditions within a foreign borrower's home country; these risks are commonly referred to as country risk. Conditions that may give rise to country risk include a country's underlying economic, political, and social trends and movements that may have potential consequences for foreigners' debt and equity investments in that country. In addition to the adverse effect that deteriorating economic conditions and political and social unrest may have on the rate of default by obligors in a country, country risk includes the possibility of nationalization or expropriation of assets, government repudiation of external indebtedness, exchange controls, and currency depreciation or devaluation. An assessment about the level of country risk should reflect an evaluation of the effect of prevailing (and possible future) economic, political, and social conditions on a country's ability to sustain external debt service, as well as reflect the impact of these conditions on the credit risk of individual counterparties located in the country.

Transfer risk is a facet of country risk. It is the possibility that an asset cannot be serviced in the currency of the payment because the obligor's country lacks the necessary foreign exchange or has put restraints on its availability.<sup>1</sup>

The traditional examination approach to commercial credit risk is treated separately in other sections of this manual. The purpose of this section is to delineate the current examination policies, objectives, and procedures for evaluating a bank's country- and transfer-risk exposures and its management system for monitoring and controlling them.

## COUNTRY RISK

Country or sovereign risk encompasses the entire

1. Exchange controls are an example of transfer risk. The Interagency Country Exposure Review Committee (ICERC) assigns ratings to foreign exposures based on its evaluation of the level of transfer risk associated with a country. See the *Guide to the Interagency Country Exposure Review Committee Process*, which was issued in November 2008, for a comprehensive discussion of the operations of the ICERC. See also section 7040.3.

spectrum of risks and factors that arise from the economic, social, and political environments of a foreign country that may have potential consequences for foreigners' debt and equity investments in that country. A detailed description of these factors is described below.

## Macroeconomic Factors

The first factor affecting country risk is the size and structure of a country's external debt in relation to its economy, more specifically—

- the current level of short-term debt and the potential effect that a liquidity crisis would have on the ability of otherwise creditworthy borrowers in the country to continue servicing their obligations, and
- to the extent the external debt is owed by the public sector, the ability of the government to generate sufficient revenues, from taxes and other sources, to service its obligations.

The condition and vulnerability of the country's current account is also an important consideration, including—

- the level of international reserves, including forward market positions of the country's monetary authority (especially when the exchange rate is fixed);
- the level of import coverage provided by the country's international reserves;
- the importance of commodity exports as a source of revenue, the existence of any price-stabilization mechanisms, and the country's vulnerability to a downturn in either its export markets or the price of an exported commodity; and
- the potential for sharp movements in exchange rates and their effect on the relative price of the country's imports and exports.

The role of foreign sources of capital in meeting the country's financing needs is another important consideration in the analysis of country risk, including—

- the country's access to international financial markets and the potential effects of a loss of market liquidity;

- the country's relationships with private-sector creditors, including the existence of loan commitments and the attitude among bankers toward further lending to borrowers in the country;
- the country's current standing with multilateral and official creditors, including the ability of the country to qualify for and sustain an International Monetary Fund or other suitable economic adjustment program;
- the trend in foreign investments and the country's ability to attract foreign investment in the future; and
- the opportunities for privatization of government-owned entities.

Past experience has highlighted the importance of a number of other important macroeconomic considerations, including—

- the degree to which the country's economy may be adversely affected through the contagion of problems in other countries;
- the size and condition of the country's banking system, including the adequacy of the country's system for bank supervision and any potential burden of contingent liabilities that a weak banking system might place on the government;
- the extent to which state-directed lending or other government intervention may have adversely affected the soundness of the country's banking system, or the structure and competitiveness of the favored industries or companies; and
- for both in-country and cross-border exposures, the degree to which macroeconomic conditions and trends may have adversely affected the credit risk associated with counterparties in the country.

## Social, Political, and Legal Climate

The analysis of country risk should also consider the country's social, political, and legal climate, including—

- the country's natural- and human-resource potential;
- the willingness and ability of the government to recognize economic or budgetary problems and implement appropriate remedial action;
- the degree to which political or regional

- factionalism or armed conflicts are adversely affecting the government of the country;
- any trends toward government-imposed price, interest-rate, or exchange controls;
- the degree to which the country's legal system can be relied on to fairly protect the interests of foreign creditors and investors;
- the accounting standards in the country and the reliability and transparency of financial information;
- the extent to which the country's laws and government policies protect parties in electronic transactions and promote the development of technology in a safe and sound manner;
- the extent to which government policies promote the effective management of the institution's exposures; and
- the level of adherence to international legal and business-practice standards.

## Institution-Specific Factors

Finally, an institution's analysis of country risk should consider factors relating to the nature of its actual (or approved) exposures in the country, including, for example—

- the institution's business strategy and its exposure-management plans for the country;
- the mix of exposures and commitments, including the types of investments and borrowers, the distribution of maturities, the types and quality of collateral, the existence of guarantees, whether exposures are held for trading or investment, and any other distinguishing characteristics of the portfolio;
- the economic outlook for any specifically targeted industries within the country;
- the degree to which political or economic developments in a country are likely to affect the institution's chosen lines of business in the country (For instance, the unemployment rate or changes in local bankruptcy laws may affect certain activities more than others.);
- for an institution involved in capital markets, its susceptibility to changes in value based on market movements (As the market value of claims against a foreign counterparty rises, the counterparty may become less financially sound, thus increasing the risk of nonpayment. This is especially true for over-the-counter derivative instruments.);

- the degree to which political or economic developments are likely to affect the credit risk of individual counterparties in the country (For example, foreign counterparties with healthy export markets or whose business is tied closely to supplying manufacturing entities in developed countries may have significantly less exposure to the local country's economic disruptions than do other counterparties in the country.); and
- the institution's ability to effectively manage its exposures in a country through in-country or regional representation, or by some other arrangement that ensures the timely reporting of, and response to, any problems.

## Risk-Management Process for Country Risk

Country risk has an overarching effect on an institution's international activities and should explicitly be taken into account in the risk assessment of all exposures (including off-balance-sheet) to all public- and private-sector foreign-domiciled counterparties. The risk associated with even the strongest counterparties in a country will increase if, for example, political, social, or macroeconomic conditions cause the exchange rate to depreciate and the cost of servicing external debt to rise. Country risk can occur in many different forms, and the nature of specific risks can change over time. A U.S. banking organization with significant direct or indirect international exposure should have in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities. Examiners should be continually evaluating the adequacy of the country-risk management process at internationally active institutions, and they should regularly update their assessments. An institution's country-risk management process should give particular attention to any concentrations of country risk.

Country risk is not necessarily limited to institutions with direct international exposures. Domestic counterparties with significant economic dependence on a foreign country or region (for example, through export dependence) can pose an indirect country risk to institutions that do not have direct international activity. While institutions are not required to incorporate indirect country risk into a formal

country-risk management process, they should nevertheless take these country-risk factors into account, where appropriate, when assessing the creditworthiness of domestic counterparties. Examiners should ensure that the overall credit-risk management process takes into account indirect country risk where applicable in all supervised institutions.

To effectively control the risk associated with international activities, institutions must have a risk-management process that focuses on the broadly defined concept of country risk. A sound country-risk management process includes effective oversight by the board of directors, adequate risk-management policies and procedures, an accurate country-exposure reporting system, an effective country-risk analysis process, a country-risk rating system, country-exposure limits, ongoing monitoring of country conditions, periodic stress testing of foreign exposures, and adequate internal controls and an audit function.

### *Oversight by the Board of Directors*

If country risk is to be managed properly, the board of directors must oversee the process effectively. The board is responsible for periodically reviewing and approving policies governing the institution's international activities to ensure that they are consistent with the institution's strategic plans and goals. The board is also responsible for reviewing and approving limits on country exposure and ensuring that management is effectively controlling the risk. When evaluating the adequacy of the institution's capital and allowance for loan and lease losses (ALLL), the board should take into account the volume of foreign exposures and the ratings of the countries to which the institution is exposed.

### *Policies and Procedures for Managing Country Risk*

Bank management is responsible for implementing sound, well-defined policies and procedures for managing country risk that—

- establish risk-tolerance limits;
- delineate clear lines of responsibility and accountability for country-risk management decisions;

- specify authorized activities, investments, and instruments; and
- identify both desirable and undesirable types of business.

Management should also ensure that country-risk management policies, standards, and practices are clearly communicated to the affected offices and staff.

### *Country-Exposure Reporting System*

To effectively manage country risk, the institution must have a reliable system for capturing and categorizing the volume and nature of foreign exposures. The reporting system should cover all aspects of the institution's operations. An accurate country-exposure reporting system is also necessary to support the regulatory reporting of foreign exposures on the quarterly Country Exposure Report, FFIEC 009.

The board of directors should regularly receive reports on the level of foreign exposures. If the level of foreign exposures in an institution is significant,<sup>2</sup> or if a country to which the institution is exposed is considered to be high risk, exposures should be reported to the board at least quarterly. More frequent reporting is appropriate when a deterioration in foreign exposures would threaten the soundness of the institution.

### *Country-Risk Analysis Process*

Although the nature of the country-risk analysis process and the level of resources devoted to it will vary from institution to institution, depending on the size and sophistication of its international operations, a number of considerations are relevant to evaluating the process in all institutions:

- Is there a quantitative and qualitative assessment of the risk associated with each country in which the institution is conducting or planning to conduct business?
- Is a formal analysis of country risk conducted

at least annually, and does the institution have an effective system for monitoring developments in the interim?

- Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any unique risks associated with specific groups of counterparties the institution may have targeted in its business strategy?
- Is the analysis adequately documented, and are conclusions concerning the level of risk communicated in a way that provides decision makers with a reasonable basis for determining the nature and level of the institution's exposures in a country?
- Given the size and sophistication of the institution's international activities, are the resources devoted to the analysis of country risk adequate?
- As a final check of the process, are the institution's conclusions concerning a country reasonable in light of information available from other sources, including external research and rating services and the Interagency Country Exposure Review Committee (ICERC)?

### *Country-Risk Ratings*

Country-risk ratings summarize the conclusions of the country-risk analysis process. The ratings are an important component of country-risk management because they provide a framework for establishing country-exposure limits that reflect the institution's tolerance for risk.

Because some counterparties may be more exposed to local country conditions than others, it is a common and acceptable practice for institutions to distinguish between different types of exposures when assigning their country-risk ratings. For example, trade-related and banking-sector exposures typically receive better risk ratings than other categories of exposure because the importance of these types of transactions to a country's economy has usually moved governments to give them preferential treatment for repayment.

The risk-rating systems of some institutions differentiate between public-sector and private-sector exposures. In some institutions, a country's private-sector credits cannot be rated less severely than its public-sector credits (that is, the institution imposes a "sovereign ceiling" on the rating for all exposures in a country). Both are acceptable practices.

An institution's country-risk ratings may dif-

<sup>2</sup> For purposes of this guidance, concentrations of exposures to individual countries that exceed 25 percent of the institution's tier 1 capital plus the ALLL are considered significant. However, in the case of particularly troubled countries, lesser degrees of exposure may also be considered to be significant.

fer from the ICERC-assigned transfer-risk ratings because the two ratings differ in purpose and scope. An institution's internally assigned ratings help it to decide whether to extend additional credit, as well as how it should manage existing exposures. Such ratings should, therefore, have a forward-looking and broad country-risk focus. The ICERC's more narrowly focused transfer-risk ratings are primarily a supervisory tool and should not replace a bank's own country-risk analysis process.

The ICERC only rates countries that are in default where U.S. banks' aggregate exposures meet certain thresholds. Default occurs when a country is not complying with its external debt-service obligations or is unable to service the existing loan according to its terms, as evidenced by failure to pay principal and interest fully and on time, arrearages, forced restructuring, or rollovers. The ICERC reviews countries to which the aggregate exposure of U.S. banking organizations is at least \$1 billion for at least two consecutive quarters or between \$200 million and \$1 billion if the exposure at five or more U.S. banks exceeds 25 percent of capital (tier 1 capital + ALLL).

For purposes of determining whether a country meets the threshold for review by the ICERC, aggregate exposure is based on the exposure reported in the most recent Country Exposure Lending Survey, which is published quarterly by the Federal Financial Institutions Examination Council (FFIEC). The Country Exposure Lending Survey summarizes the aggregate, by country, exposures of U.S. banks, bank holding companies, and Edge and agreement corporations filing the FFIEC 009 regulatory reporting form (Country Exposure Report). Specifically, aggregate exposure is the sum of "Transfer Risk Claims" and "Unused Commitments" and "Guarantees and Credit Derivatives."<sup>3</sup>

If a country in default does not meet at least one of the exposure criteria for two consecutive quarters, the committee decides whether it should continue to be reviewed based on the number of banks with exposure and the trend of conditions in the country.

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3. The "Guarantees and Credit Derivatives" component captures the notional value of credit derivatives sold. This measure is a conservative estimate of contingent liabilities where a bank has taken exposure to a referenced credit in the given country. Netting does not take place in the reporting of credit derivatives since counterparty positions may not offset.

### *Country-Exposure Limits*

As part of their country-risk management process, internationally active institutions should adopt a system of country-exposure limits. Because the limit-setting process often involves divergent interests within the institution (such as the country managers, the institution's overall country-risk manager, and the country-risk committee), country-risk limits will usually reflect a balancing of several considerations, including—

- the overall strategy guiding the institution's international activities,
- the country's risk rating and the institution's appetite for risk,
- perceived business opportunities in the country, and
- the desire to support the international business needs of domestic customers.

Country-exposure limits should be approved by the board of directors, or a committee thereof, and communicated to all affected departments and staff. Exposure limits should be reviewed and approved at least annually—and more frequently when concerns about a particular country arise.

An institution should consider whether its international operations are such that it should supplement its aggregate exposure limits with more discrete controls. Such controls might take the form of limits on the different lines of business in the country, limits by type of counterparty, or limits by type or tenor of exposure. An institution might also limit its exposure to local currencies. Institutions that have both substantial capital-market exposures and credit-related exposures typically set separate aggregate exposure limits for each because exposures to the two lines of business are usually measured differently.

Although country-by-country exposure limits are customary, institutions should also consider limiting (or at least monitoring) exposures on a broader (for example, regional) basis. A troubled country's problems often affect its neighbors, and the adverse effects may also extend to geographically distant countries with close ties through trade or investment. By monitoring and controlling exposures on a regional basis, institutions are in a better position to respond if the adverse effects of a country's problems begin to spread.

For institutions that are engaged primarily in direct lending activities, monthly monitoring of compliance with country-exposure limits is adequate. However, institutions with more volatile portfolios, including those with significant trading accounts, should monitor compliance with approved limits more frequently. Exceptions to approved country-exposure limits should be reported to an appropriate level of management or the board so that it can consider corrective measures.

### *Monitoring Country Conditions*

The institution should have a system in place to monitor current conditions in each of the countries where it is significantly exposed. The level of resources devoted to monitoring conditions within a country should be proportionate to the institution's level of exposure and the perceived level of risk. If the institution maintains an in-country office, reports from the local staff are an obviously valuable resource for monitoring country conditions. In addition, periodic country visits by the regional or country manager are important to properly monitor individual exposures and conditions in a country. The institution may also draw on information from rating agencies and other external sources.

Communication between senior management and the responsible country managers should be regular and ongoing. The institution should not rely solely on informal lines of communication and ad hoc decision making in times of crisis. Established procedures should be in place for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country.

### *Stress Testing*

Institutions should periodically stress-test their foreign exposures and report the results to the board of directors and senior management. As used here, stress testing does not necessarily refer to the use of sophisticated financial modeling tools, but rather to the need for all institutions to evaluate in some way the potential impact different scenarios may have on their country-risk profiles. The level of resources devoted to this effort should be commensurate with the significance of foreign exposures in the institution's overall operations.

### *Internal Controls and Audit*

Institutions should ensure that their country-risk management process includes adequate internal controls and that an audit mechanism ensures the integrity of the information used by senior management and the board to monitor compliance with country-risk policies and exposure limits. The system of internal controls should, for example, ensure that the responsibilities of marketing and lending personnel are properly segregated from the responsibilities of personnel who analyze country risk, rate country risk, and set country limits.

## TRANSFER RISK

Transfer risk focuses on a borrower's capacity to obtain the foreign exchange required to service its cross-border debt. The examination of transfer risk entails (1) the identification of selected country exposures of a bank that are considered significant relative to the bank's capital and the economic performance of the country; (2) the classifications of substandard, value-impaired, and loss; (3) a determination as to the adequacy of mandated special reserves against certain international assets classified value-impaired; (4) the analysis of those non-classified credits that warrant bank management's close attention and concentrations that warrant special comment; and (5) an in-depth assessment of the adequacy of the systems the bank employs to monitor and control this facet of international lending. Four report pages have been designed to reflect an examiner's analysis of the transfer-risk element in international lending for a particular bank, as follows.

The first page, "Selected Country Exposures," merely lists, without comments, exposures that are deemed significant in relation to a bank's capital and the economic performance of the country. Exposures, depending on the country grouping, are taken from the bank's last quarterly Country Exposure Report, FFIEC 009, and compared with the bank's capital as of the same date.

The second page, "Classifications Due to Transfer Risk," reflects credits ICERC has classified because of their transfer risk. Totals in each classification should be carried forward to the "Summary of Classified Items" page, with adjustments to eliminate those credits classified

because of commercial risk, in accordance with the instructions in section 7040.3.

In December 1983, the federal banking agencies adopted examination categories for identifying credits that have been adversely affected by transfer-risk problems. In addition, the International Lending Supervision Act of 1983 requires banks to establish and maintain a special reserve when the value of international assets has been impaired by a protracted inability of the borrowers in a country to make payments on external indebtedness or when no definite prospects exist for orderly restoration of debt service. Both issues are outlined in section 7040.3.

The third page, “Nonclassified Credits Warranting Attention II; Concentrations of Transfer Risk Warranting Special Comment,” identifies exposures, as of the examination date, in which

a combination of the amount outstanding in relation to the bank’s capital funds, the composition of the portfolio, and the economic performance of the country would warrant the bank to focus special attention on its exposure.

The fourth page, “Analysis of the Country Exposure Management System,” presents in narrative form an assessment of a bank’s system for monitoring and controlling its transfer-risk exposures. Included are comments relative to the bank’s procedures for measuring exposure, the system for establishing country lending limits, and the bank’s capability to analyze countries. Examination Conclusions and Comments in the report of examination may range from criticisms of weaknesses in the country-exposure-management system to high concentrations of risk in potentially weak or problematic countries.

# International—Country Risk and Transfer Risk

## Examination Objectives

Effective date April 2009

Section 7040.2

### COUNTRY-RISK MANAGEMENT

1. If the bank is internationally active, to determine the nature and extent of the bank's direct and indirect country-risk exposure.
2. If the bank has significant direct or indirect international exposure, to evaluate and determine whether it has in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities.
3. To review and determine if the bank's system of policies, procedures, and internal controls and if its rating system and stress testing for country-risk management are adequate and reliable.
4. To determine if the bank's board of directors oversees and regularly reviews its country-risk management process, approves limits on country exposure, provides for adequate capital that is commensurate with its direct and indirect country-risk exposures, and ensures that management is effectively controlling the risk.
5. To determine if management clearly communicates the bank's country-risk management policies, standards, and practices to the affected offices and staff.
6. To determine if the scope of the bank's audit function is adequate and if the function is sufficiently comprehensive to ensure the integrity of the information senior management and the board use to monitor the bank's country-risk management process. To ensure that the board of directors or its audit committee has provided for adequate audit coverage of country-risk management functions.
7. To recommend corrective action if a bank's country-risk management process and controls are deficient in relation to the level of country-risk exposure.
8. To determine if the bank is properly preparing the Country Exposure Report, FFIEC 009, which is required to be filed quarterly with the Federal Reserve Bank of New York.
9. To identify and report individual country exposures considered significant in relation to the bank's capital and the economic performance of the country.

### CLASSIFICATIONS DUE TO TRANSFER RISK

1. To evaluate the portfolio to identify those credits in countries considered subject to classification by the Interagency Country Exposure Review Committee (ICERC).
2. To determine if the bank has adequately provided the required allocated transfer risk reserves for those international assets included in the country exposures classified value impaired.
3. To develop information on the composition of those exposures subject to classification.
4. To prepare report pages on all transfer risks subject to classification.
5. To determine the effect of total transfer-risk classifications on the overall quality of the international loan portfolio, as well as on the total bank.

### NONCLASSIFIED CREDITS WARRANTING ATTENTION—CONCENTRATIONS OF TRANSFER RISK WARRANTING SPECIAL COMMENT

1. To identify and report any concentrations of transfer risk warranting special comment.
2. To develop information on the composition of those concentrations for the report page.

### ANALYSIS OF THE COUNTRY-RISK MANAGEMENT SYSTEM

1. To determine if the bank's policies, practices, procedures, and internal controls for the management of transfer risk are adequate.
2. To determine if bank officers are operating in conformance with established guidelines.
3. To prepare narrative commentary on the bank's country-exposure management system and on any noted deficiencies, in a concise reportable format.



### COUNTRY RISK

Country risk, which has an overarching effect on the realization of an institution's foreign assets, encompasses all of the uncertainties arising from the economic, social, and political conditions in a country. It includes the possibility of deteriorating economic conditions, political and social upheaval, nationalization and expropriation of assets, government repudiation of external indebtedness, exchange controls, and currency depreciation or devaluation.

#### Analysis of the Country-Risk Management System

Generally, all banks have systems for appraising, monitoring, and controlling their foreign-lending activities. These systems differ from bank to bank in terms of the measure of the outstanding exposure, the independence of transfer-risk assessments and control from marketing considerations, the capability to make country judgments on the basis of analytical factors and firsthand knowledge of the country, the centralization and formality of procedures, and the level of in-depth review. When performing and updating the bank's risk assessment, the central point of contact for the institution should include an analysis of the institution's direct and indirect country-risk exposures (including any significant country-risk concentrations) and the adequacy and reliability of its country-risk management. Given the variations, banks' country-risk management systems should consist of three important components.

One component is the provision for evaluation of economic trends, political developments, and the social fabric within countries where bank funds are at risk. These so-called country studies are derived from economic data supplied by the borrower or published by institutional lenders; sociopolitical commentaries; on-site reports from bank branches, subsidiaries, or affiliates; or bank-officer visits to the country.

The second component involves the undertaking by the board of directors and senior management to define the level of country exposure the bank is willing to assume. This undertaking normally includes the establishment of limits

on aggregate outstandings, maturities, and categories of risk exposures by country, which serve as a guide to operating management in the development and servicing of the bank's international credit portfolio.

The third component is the bank's internal-reporting system designed to monitor and control country exposure. A comprehensive reporting system is required to accurately assign risk exposures to the country of risk, ensure adherence to the directives of the board, provide for at least an annual review of portfolio composition in individual countries, and establish a clear-cut methodology for reporting exceptions to established limits.

A summary of the country-risk management system should be prepared. Set forth below are guidelines and procedures for examiners to use in evaluating the systems banks use to monitor and control country-risk elements in their international loan portfolios. In assessing the quality of the country-risk management system, examiners should, as a matter of course, spot-check the accuracy of the data submitted on the Country Exposure Report, FFIEC 009. The review should include the exposures for at least several countries. Material exceptions should be commented on. To prepare this summary, the examiner should perform the following procedures:

1. Obtain any written policies, procedures, or summaries of the bank's country-risk management system. Determine whether the bank's country-risk management system includes—
  - a. effective oversight by the board of directors,
  - b. adequate risk-management policies and procedures,
  - c. an accurate country-exposure reporting system,
  - d. an effective country-risk analysis process,
  - e. a country-risk rating system,
  - f. country-exposure limits,
  - g. ongoing monitoring of country conditions,
  - h. periodic stress testing of foreign exposures, and
  - i. adequate internal controls and an audit function. (See SR-02-5.)

2. Obtain the following from a review of the minutes and reports of the board of directors:
    - a. a copy of written policies covering transfer risk
    - b. the name and composition of the committee responsible for administration of transfer risk
  3. Review international-lending policies and determine—
    - a. if the board of directors regularly reviews and gives final approval to the limits on country exposure at least annually (or quarterly, if the foreign exposures are high risk or the concentrations are significant);
    - b. who initiates the country ratings and country limits;
    - c. how frequently and by whom country ratings and limits are reviewed and changed;
    - d. how the bank defines the ratings assigned to the various countries;
    - e. how country limits are determined;
    - f. who is responsible for monitoring compliance with country limits;
    - g. if country-risk limits consider—
      - the overall strategy guiding the institution's international activities,
      - the country's risk rating and the institution's appetite for risk,
      - perceived business opportunities in the country, and
      - the desire to support the international business needs of domestic customers;
    - h. to what extent country limits are viewed as guidelines that may be exceeded;
    - i. if the bank has different sublimits for private- and public-sector credits;
    - j. if separate limits are established for private- and public-sector credits;
    - k. if the board of directors or a committee thereof periodically reviews country ratings and limits, and evaluates the bank's performance against those standards;
    - l. to what extent comments or classifications of bank supervisors are considered in establishing, increasing, or decreasing country limits;
    - m. how the system has been changed since the last examination;
    - n. if the bank has a reliable system for capturing and categorizing the volume and nature of foreign exposures;
    - o. whether the bank has a system to monitor current conditions in each of the countries where it is significantly exposed;
    - p. if there is regular, ongoing communication between senior management and the responsible country managers;
    - q. if established procedures are in place for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country; and
    - r. whether the bank periodically conducts stress tests (financial modeling or measuring the impact of various scenarios on its country-risk profiles) of its foreign exposures and if the results are reported to senior management and the board of directors.
  4. Review reports furnished to the board or the appropriate committee to ensure that comprehensive and accurate information is being submitted on a timely basis.
  5. Obtain the bank's report on the general distribution and characteristics of the international loan portfolio and compare loan-category distributions for adherence to guidelines.
  6. During discussion with senior management, direct inquiries to—
    - a. gain insight into general management's international lending philosophy, and
    - b. elicit management responses for correction of deficiencies.
- When reporting on the bank's country-risk management system, the examiner should consider factors such as—
1. the quality of internal policies, practices, procedures, and controls over the international-lending functions;
  2. the scope and adequacy of the internal loan-review system as it pertains to country risk;
  3. causes of existing problems;
  4. commitments from management for correction of deficiencies;
  5. expectations for continued sound international lending or correction of existing deficiencies;
  6. the ability of management to monitor and control transfer risk;
  7. the general level of adherence to internal policies, practices, procedures, and controls; and
  8. the scope and adequacy of the bank's analysis of country conditions.

## TRANSFER RISK

Transfer risk is one facet of the more broadly defined concept of country risk. Transfer risk focuses more on the availability of foreign exchange to service a country's external debt.

The transfer-risk examination procedures emphasize diversification of exposure in relation to a bank's capital as the primary method of moderating transfer risk. Where concentrations are noted, the degree of risk inherent therein is assessed in light of the composition of the portfolio and the general economic and political factors that may affect the debt-service capacity of the individual countries.

## INTERAGENCY COUNTRY EXPOSURE REVIEW COMMITTEE

The Interagency Country Exposure Review Committee (ICERC) is responsible for providing an assessment of the degree of transfer risk that is inherent in the cross-border and cross-currency exposures of U.S. banks. The ICERC's transfer-risk ratings are primarily a supervisory tool and should not replace a bank's own country-risk analysis process. Supervisors expect institutions under their supervision to continue to monitor closely their cross-border exposure to all countries; to have robust country-risk assessment systems; to have appropriate sovereign exposure limits in place for each sovereign entity; to perform solid financial analysis on the sovereign entities to which the institutions are exposed; and, generally, to continue to apply sound risk management to all of their cross-border exposures, not just to the countries rated by ICERC. Such risk-management functions will continue to be evaluated during the course of regular supervisory examinations. While banks are advised of the results of the ICERC's evaluations, this information is sensitive, and adequate safeguards should be established to ensure that it is not accessible to unauthorized personnel. The chief executive officers of those banks filing the quarterly FFIEC 009 receive copies of the write-ups on classified countries for *only* those classifications applicable to their own bank. In no event should the complete listing of country groupings be divulged. This approach parallels that of the Shared National Credit Program.

To promote uniform and consistent application of these procedures, examiners should avoid ad hoc interpretations of the instructions and should address all questions to their respective offices. The federal banking agencies have developed a publication, *Guide to the Interagency Country Exposure Review Committee Process*, to clarify and make more transparent the role of the ICERC in the supervisory process. (See SR-08-12.)

## Application of ICERC Ratings

ICERC transfer-risk ratings are applicable in—

- every U.S.-chartered insured commercial bank in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions;
- every U.S. bank holding company, including its Edge and agreement corporations and other domestic and foreign nonbank subsidiaries; and
- the U.S. branches and agencies of foreign banks (however, the allocated transfer-risk reserve (ATRR) requirement does not apply to these entities).

ICERC ratings are generally applicable to all types of foreign assets held by an institution, with the exception of premises, other real estate owned, and goodwill. For purposes of the ICERC rating, the determination of where the transfer risk for a particular exposure lies takes into consideration the existence of any guarantees and is based on the country of residence of the ultimate obligor. (See the instructions for the FFIEC 009.)

The ICERC transfer-risk rating is the only rating applicable to sovereign exposures in a reviewed country (that is, direct or guaranteed obligations of the country's central government or government-owned entities). However, if they are carried on the institution's books as an investment, securities issued by a sovereign entity are also subject to the FFIEC's Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks. The FFIEC agreement provides for specific, and possibly more severe, classification treatment of sub-investment-quality securities. Furthermore, except as noted in the next paragraph, the ICERC transfer-risk rating is also the minimum

risk rating applicable to *all other* cross-border and cross-currency exposures of U.S. banks in a reviewed country.

Regardless of the currencies involved, to the extent that an institution's claims on local country residents are funded by liabilities to local country residents, the ICERC's transfer-risk ratings *do not* apply. For example, to the extent that it has liabilities to local residents (such as sterling deposits), claims of the London branch of a U.S. bank on a public- or private-sector obligor in the United Kingdom (whether the claims are denominated in sterling, dollars, or euros) are not subject to the ICERC transfer-risk rating.

The ICERC is not able to evaluate the credit risk associated with individual, private-sector exposures in a country. Therefore, based on an evaluation of credit-risk factors (including the effects of country risk), examiners may assign credit-risk ratings to individual, private-sector exposures that are more severe than the ICERC-assigned transfer-risk rating for the country. For any given private-sector exposure, the applicable rating is *the more severe* of either the ICERC-assigned transfer-risk rating for the country or the examiner-assigned credit-risk rating (including ratings assigned as a result of the Shared National Credit Program).

Questions sometimes arise concerning the consideration that examiners should give to informal expressions of support by the central government of a country for a particular borrower or sector of the economy (most often, banking). Unless they constitute a guarantee or other legally binding commitment, examiners should view such expressions of support as no more than a mitigating factor in their evaluation of the counterparty's credit risk. Informal expressions of support by the central government would not cause the counterparty's credit-risk rating to revert to the ICERC-assigned transfer-risk rating for the country.

## Special Categories of Exposure

Although the ICERC may have rated ordinary short- and/or long-term exposures in a country as substandard, value-impaired, or loss, several special categories of exposure in a country may receive a less severe transfer-risk rating if certain conditions are met, as described below.

- *Performing short-term bank and performing short-term trade exposures.*<sup>1</sup> Short-term bank and trade exposures, which have maturities of one year or less, are generally considered to have a lower level of transfer risk because, historically, they have received priority in the allocation of a country's foreign-exchange resources. In recognition of their historical performance, the ICERC usually assigns a more favorable rating to these types of exposures.
- *Securities held in trading accounts.* Presuming that there is an active and liquid market for the securities and that the bank has procedures in place to appropriately value them, the ICERC may, on a case-by-case basis, assign a less severe transfer-risk rating to specific securities held in the bank's trading account. In any case, because FASB Financial Accounting Standard No. 115 requires that they be marked-to-market, trading-account securities are not subject to an ATRR requirement.
- *Direct-equity investments.* The ICERC may, on a case-by-case basis, assign a less severe transfer-risk rating to specific direct-equity investments when *all* of the following conditions are met:
  - The investment has been marked-to-market or is valued using the equity-accounting method.
  - The institution has provided the ICERC with evidence that the foreign business is financially viable.
  - The institution has provided the ICERC with evidence of its ability to repatriate dividends, interest payments, and proceeds from the sale of assets on a timely basis.

## EXAMINATION REPORTING OF TRANSFER RISK

The entire examination section dealing with transfer risk should be placed in an international

1. A *performing credit* is current and has not been restructured to avoid delinquency or because of a deterioration in the financial condition of the borrower. A credit is considered "current" if it has not been reported as "past due" or "nonaccrual" for the bank call report. *Trade credit* consists of credit extensions that are directly related to imports or exports and that will be liquidated through the proceeds of international trade. These credit extensions will include pre-export financing only when there is a firm export sales order and the proceeds of the order will pay off the indebtedness.

operations section of the commercial report of examination. In addition, the discussion of transfer-risk assets should be separated from the discussion of all other loans and assets classified or specially mentioned elsewhere in the report.

## Selected Country Exposures

A list should be presented of those transfer-risk exposures considered large relative to the bank's own capital funds, after taking into account the economic, social, and political circumstances within a country. These exposures, which comprise total claims and contingencies, should be taken from the last quarterly FFIEC 009 filed by the bank under examination and compared with consolidated bank capital as of the same date. For this purpose, capital is defined as tier 1 and tier 2, and it should be footnoted as such on this page. The examiner should also note that this report of country exposure and its comparison with bank capital may differ from actual exposure as of the date of examination. The level at which exposure is listed is based on a review of the performance of each country by the ICERC.

Examiners are encouraged to review the instructions for preparing the country-exposure report for further information concerning the preparation of this page. While it is not expected that examiners review the country-exposure reports filed between examinations for accuracy, a spot-check to verify that such reports are being prepared properly should be made. Material reporting errors uncovered during the examination should be included in comments on reporting exceptions elsewhere in the report of examination. When bank management relies on the data generated for the country-exposure report, and when reporting exceptions are noted, comments should be incorporated in the analysis of the country-risk management system.

## Ratings and Classifications Due to Transfer Risk

A list of exposures subject to classification as a result of transfer-risk considerations should be prepared. The decision to classify a bank's exposure to a particular country is made by the ICERC based on criteria incorporated into the

provisions of the International Lending Supervision Act of 1983.

The ICERC's assessment of transfer risk reflects the committee's application of the following category definitions.

### *Substandard*

This category applies when a country is not complying with its external debt-service obligations, as evidenced by arrearages, forced restructuring, or rollovers; and if either of the two following conditions exists:

- The country is not in the process of adopting an IMF or other suitable economic adjustment program, or is not adequately adhering to such a program.
- The country and its bank creditors have not negotiated a viable rescheduling and are unlikely to do so in the near future.

### *Value-Impaired*

A country has protracted arrearages, as indicated by more than one of the following:

- The country has not fully paid its interest for six months.
- The country has not complied with IMF programs (and there is no immediate prospect for compliance).
- The country has not met rescheduling terms for more than one year.
- The country shows no definite prospects for an orderly restoration of debt service in the near future.

### *Loss*

A loan is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. An example would be an outright repudiation by a country of its obligations to banks, the IMF, or other lenders.

The ICERC also prepares the write-ups supporting each classification. Examiners are to provide commentary on the disaggregation of each country exposure subject to classification. Include comments relative to the bank's country lending limit and any references to any proposed increases or decreases to such limit.

The examiner's commentary is to be followed by a standardized write-up on each country for which the bank has exposures, prepared by the ICERC.

## ALLOCATED TRANSFER RISK RESERVE

The responsibility for recognizing and accounting for deterioration in the value of a bank's assets, including a deterioration due to transfer-risk problems, rests with the management of a bank and its auditors. The banking agencies also have a responsibility to ensure that banks are following reasonable and prudent policies in this regard, and that necessary adjustments are being made consistently. To ensure this, the federal banking agencies, pursuant to the International Lending Supervision Act, require U.S. banks to establish an ATRR on a consolidated basis against the risks presented in certain international assets whose value has been found by the ICERC to have been significantly impaired by protracted transfer-risk problems. The ATRR should be applied to certain international assets that have been classified for transfer-risk reasons as value-impaired. The act also requires that the ATRR be established by a charge against current income, be segregated from the bank's allowance for loan and lease losses (ALLL), be deducted from gross loans and leases, and not be included as part of bank capital.

The alternative to establishing an ATRR is the direct charge to the ALLL or a reduction in the principal amount of the asset by applying interest payments or other collections on the asset. However, if this alternative accounting treatment is used, the institution may not write up the value of the assets if the ATRR requirement is later reduced or eliminated. No ATRR provisions are required if the bank has previously written down or charged off the requisite amounts. Furthermore, no ATRR will be required on contingent liabilities. Instead, contingent liabilities to value-impaired countries will be reviewed on a case-by-case basis.

The ATRR amounts mandated will be reviewed regularly by the ICERC to determine if additional reserves are required or whether downward adjustments need to be made. Initially, special reserves would not apply to net new lending when additional loans are made in

the context of an IMF or other appropriate economic adjustment program, and when the lending generally enhances the debt-service capability of the country concerned. Whether an ATRR is subsequently required for these new loans would be determined by the ICERC on the basis of performance and the continued inapplicability of the established criteria.

To calculate the reserves, examiners must multiply the reserve percentage times the amount of the adjusted exposure subject to transfer risk and the ATRR. This calculation should be done on the face amount of each loan outstanding before deducting any previous write-downs. For purposes of this computation (as noted above), interest payments that have been applied to existing loan balances are tantamount to write-downs and are an acceptable alternative to the establishment of an ATRR. The number derived after the calculation should be netted against previous write-downs to arrive at the mandated ATRR. In accordance with SR-92-2, the resulting net exposure, after adjusting for the ATRR, is included in the total classified value-impaired, but is weighted like a substandard credit *only* in determining the asset quality of the bank and other measures of financial soundness. The resulting net exposure, after adjustment for the ATRR, is included in the total classified value-impaired and is looked on as a doubtful classification *only* in determining the asset quality of the bank and other measures of financial soundness. When a shortfall exists, management should be apprised and be expected to comply with the statute in establishing the required reserve. Remarks relative to any shortfall and management's actions should be made in the Examination Conclusions and Comments. Although the general rule is that all exposures rated value-impaired are subject to the ATRR requirement, over the years there have been a number of clarifications and refinements. (See 12 CFR 28, 211.43, and 347.)

Aggregate exposures rated "Substandard" are relevant to any assessment of possible concentrations of risk, and should be factored into the evaluation of the adequacy of the bank's capital and ALLL.

## OTHER MATTERS

### Discussion of Transfer Risk in the Examiner's Comments and Conclusions

As a general rule, classifications due to transfer risk are included in the total assets classified and discussed under a major heading, such as "Asset Quality." Transfer-risk classifications of any significance should be highlighted. When the bank has other exposures of concern that warrant not only senior management's special attention, but the attention of the bank's board of directors, comments may be generated under a separate caption entitled "Transfer Risks." The examiner should include comments relative to the classifications; the shortfall, if any, in the mandatory reserves against exposures considered value-impaired; concentrations warranting special comment; and any other noted deficiency, such as an ineffective country-risk management system.

### Sharing Information with State Banking Examiners

When an examination of a state member bank is being conducted concurrently or on a joint

basis with state authorities, Federal Reserve examiners may share with state banking examiners information on those countries to which the bank under examination has exposures subject to classification or comment.

### Country Categories

The complete listing of countries as prepared by the ICERC is highly confidential and for internal use only. In discussions with bank management, examiners should refer only to countries that will be commented on in that bank's examination report. In this context, any reference to a "categorization" of countries should be couched in neutral terms.

Examiners are to provide the examiner-in-charge with essential information that will help facilitate future examinations. In addition, all workpapers should be maintained in an orderly manner, properly labeled, and available for inspection when and if necessary.

# International—Country Risk and Transfer Risk

## Internal Control Questionnaire

Effective date April 2009

## Section 7040.4

1. Has the board of directors, consistent with its duties and responsibilities, adopted written objectives and policies for international loan portfolio management? Do these policies and objectives—
  - a. establish country-exposure limits for credits, including sublimits for transfer risk?
  - b. establish limits for distribution of credits by type and maturity?
  - c. acknowledge concentrations of credit within countries, and acknowledge the need to employ personnel with appropriate specialized knowledge and experience to supervise those concentrations?
2. Are objectives and policies for international loan portfolio management reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are significant changes in country conditions or levels of exposure promptly brought to the attention of the board of directors or its designated committee?
4. Are country limits revised in response to substantive changes in economic, political, and social conditions within particular countries?
5. Is a formal analysis of country risk prepared, and are country limits reviewed, updated, and approved by the board of directors at least annually?
  - a. Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any unique risks associated with specific groups of counterparties the institution may have targeted in its business strategy?
  - b. Is the analysis adequately documented, and are conclusions concerning the level of risk communicated in a way that provides decision makers with a reasonable basis for determining the nature and level of the institution's exposures in a country?
  - c. Are the bank's conclusions concerning a country reasonable in light of information available from other sources, including external research and rating services and the Interagency Country Exposure Review Committee (ICERC)?
6. Before granting additional advances or commitments, are outstanding advances or commitments checked against appropriate country limits?
7. Are lending officers cognizant of specific country limitations?
8. Are procedures for exceeding country limits clearly defined?
9. Does the bank have a periodic foreign call program for countries?
10. Is there an internal-review system to determine that international risk assets outstanding and committed are within the bank's foreign-exposure limits?
11. Are country-risk factors (economic, political, and social) and other factors in a particular country considered in the bank's internal periodic review of its risk assets?
12. Does the bank have an adequate, current system for country-risk analysis? Does the system consist of a regular, periodic quantitative and qualitative assessment and review of risk for each country in which the bank conducts or plans to conduct business, and does this system include—
  - a. a review of country conditions on a regular basis (state the frequency and indicate who performs analyses)?
  - b. a continuing review of current country data obtained from internal and external sources?
  - c. an analysis of economic, political, social, and other factors affecting country risk?
13. Does the bank have a formal reporting system on country risk?
14. Does the reporting system provide complete exposure data quickly and in sufficient detail to assess particular risks?
15. Does the bank's country-risk evaluation system accurately recognize exposure from country to country, on the basis of legally binding guarantees, collateral, or reallocation by the office of responsibility?
16. Given the size and sophistication of the institution's international activities, are the resources devoted to the analysis of country risk adequate?
17. Is a regular determination made about each country's transfer risk, including whether transfer risk is increased due to the bank's heavy debt servicing or other financial



restraints, and whether the country has exchange controls and hard-currency restrictions?

18. Has the bank adequately provided the required allocated transfer risk reserves for

those international assets that are included in the country exposures classified value-impaired?

### INTRODUCTION

Financing foreign receivables, a specialized area of commercial lending in an international banking division, includes open-account financing, sales on consignment, advances against collections, discounting trade acceptances, banker's acceptances, factoring, and forfaiting. Certain foreign receivables are guaranteed or insured against cross-border risk by the Export-Import Bank of the United States, the Foreign Credit Insurance Association, and other U.S. and foreign organizations. Factoring is discussed in section 2180 of this manual, and accounts receivable financing is discussed in section 2160 (Asset-Based Lending) of this manual.

### OPEN-ACCOUNT FINANCING

The simplest method of financing foreign receivables is on open account. In this type of sale, the buyer and seller agree on payment at a specified date without a negotiable instrument, such as a draft or acceptance, evidencing the obligation. In most instances, the shipping documents are sent directly to the buyer rather than through a bank. The exporter may request that the buyer make payment to the bank at which the exporter maintains an account. The advantages of an open-account sale are its simplicity, lack of bank charges, and the avoidance of stamp duties that certain countries apply to drafts.

The financing of open-account sales does have certain risks. Neither the lending bank nor the exporter have control over the shipping documents, and the buyer (importer) may take possession of the goods without the consent of the bank or exporter. In addition, if the importer does not register the goods with the proper authorities, the importer may not have access to the amount of foreign exchange necessary to pay for the imports at the time of payment. Perhaps the greatest risk in open-account financing is the lack of standard trade-financing documentation on which to base legal action against the importer in the event of default. Therefore, open-account sales are most appropriate when the buyer is a subsidiary of a related company or is well known to the seller and when the importing country has no significant economic, political, or social problems and,

consequently, is not encountering foreign-exchange difficulties.

### SALES ON CONSIGNMENT

Under a consignment arrangement, goods are consigned to the importer (consignee) abroad, and the exporter (consignor) retains title to them until they are sold to a third party. However, unless the shipment is made to an exporter's overseas branch or subsidiary, the exporter's credit risk may be considerable. As with open-account sales, there is a lack of standard trade-financing documentation on which to base legal action if the consignee defaults. The exporter should thoroughly understand the inherent credit risks, especially when goods are consigned to an agent, representative, or import house abroad.

In countries with free ports or free trade zones, consigned goods may be placed under bonded warehouse control in the name of a foreign bank or branch of the bank. Arrangements may then be made to release the consigned merchandise at the time it is sold. Merchandise is cleared through customs after the sale has been completed. However, that type of consignment should not be made and will not usually be accepted by foreign banks until all pertinent conditions and regulations are verified and storage facilities are arranged. The exporter's bank also should verify that goods not sold may be returned to the country of origin. Consignment shipments financed by the bank should be limited to countries that do not have burdensome foreign-exchange restrictions and that have sufficient foreign exchange available to pay for imports.

To overcome the disadvantages of financing shipments on an open-account or consignment basis, exporters frequently ship goods against documentary collections. Consequently, the exporter, in the case of a time or arrival draft, or the exporter and the importer jointly, in the case of a sight draft, finance the shipment. The exporter and the importer may have unused credit lines with their banks and be in a position to borrow the needed money without tying the financing to the trade transaction. However, often the exporter's or the importer's regular bank lines are fully drawn down, so they may seek bank financing in the form of advances

against outward collections, discounting trade acceptances, banker's acceptances, factoring, or forfaiting.

## ADVANCES AGAINST FOREIGN COLLECTIONS

A manufacturer or merchant conducting a strictly domestic business often obtains a loan from a bank, finance company, factor, or forfaiter using accounts receivable as security. The same general type of financing vehicle is available to exporters to finance their foreign receivables.

A common method of financing foreign receivables is through the exporter pledging all outward collections to its bank. The exporter may then borrow from the bank up to a stated maximum percentage of the total amount of receivables pledged at any one time. When notes rather than drafts are used to finance foreign receivables, they are usually paid on demand, enabling the exporter to increase or decrease the loan depending on its needs and the current amount of collections outstanding. Preferably, all of the collections lodged with the exporter's bank should be pledged to the bank. When a particular collection is paid, it is remitted by a foreign collecting bank to the exporter's bank, which has already advanced the funds to the exporter. The exporter's bank then uses the proceeds of the collection to reduce the exporter's loan.

Some exporters have no need for a continuous financing arrangement but occasionally may wish to obtain financing on only one large foreign receivable. In these instances, the exporter's bank may be willing to advance funds to the exporter with only that one receivable as security. Again, the bank establishes a maximum percentage of the amount of the receivable that it is willing to advance. When payment for the receivable is obtained, the bank uses the proceeds to liquidate the loan, crediting any excess to the exporter. Bank financing in the form of advances against export receivables is an accepted practice in international trade and is not considered factoring.

Besides having a lien on the exporter's outward collections, the bank usually retains recourse to the exporter, whose credit strength and reputation are of prime importance. Other factors, however, are also significant. If the foreign importers are companies with strong

reputations and financial strength, the bank will likely advance a larger percentage on collections directed to them. The bank will also likely advance a larger percentage of funds to importers in those countries in which importers promptly pay drafts drawn on them. In other countries where payment is generally slow, perhaps because importers are financially weak or because U.S. dollar or other foreign-currency exchange is hard to obtain, the bank will advance a lower percentage on collections. The exporter's bank may be completely unwilling to finance collections directed to importers or countries with reputations for habitually slow payments.

When a bank advances against foreign receivables, it must carefully scrutinize the supporting documents. Since the bank wishes to maintain control of the merchandise, the bill of lading should be either "to the order of" the shipper and blank-endorsed or "to the order of" the bank. The bill of lading must not be consigned to the buyer (importer) since this gives the buyer control over the goods. Also, financed shipments should be covered by adequate insurance.

## DISCOUNTING TRADE ACCEPTANCES

A draft accepted by the foreign importer becomes a trade acceptance carrying the full credit obligation of the importer. These trade acceptances are also frequently called "trade bills" or "trade paper." The acceptance is returned to and becomes the property of the exporter, who will ask the collecting bank to present it to the importer or acceptor for payment at maturity. The exporter is, therefore, providing the financing or "carrying" its own foreign receivables. However, if the exporter needs the funds before maturity of the trade acceptance, the exporter may ask the bank to "discount" the draft. If the primary obligor (the acceptor) is a well-known company of good credit standing, the bank may be willing to discount the draft without recourse to the exporter. More commonly, however, the lending bank looks to the exporter for recourse should the primary obligor fail to pay the amount when due.

When discounting a trade acceptance, the bank applies a discount to the face amount of the draft and advances the remainder to the exporter until the draft's maturity. The bank is "buying" the trade acceptance for value and is entitled to

any benefits from the primary obligor to which it is due as a holder in due course of a negotiable instrument. This is also the case whenever the bank advances against a single collection or a pool of collections. Any intermediary “collecting” bank also has a financial interest in the collection and has all the rights of a holder in due course under the Uniform Commercial Code.

## **BANKER’S ACCEPTANCES CREATED AGAINST FOREIGN COLLECTIONS**

During periods of tight money, banks may choose to finance foreign collections by using banker’s acceptances. Banker’s acceptances are discussed in section 7060, “International—Banker’s Acceptances,” so the following comments relate only to the financing of foreign collections.

As with all acceptance financing, the exporter first submits a signed acceptance agreement to its bank. To obtain acceptance financing for foreign receivables, the exporter draws two drafts. The first is a time draft drawn on the foreign buyer (the importer) that, along with the necessary documents, is sent for collection in the usual manner. The second draft, for the same or a smaller amount as agreed to by the bank and the exporter, is drawn by the exporter on its bank and has the same tenor as the draft drawn on the importer. The bank accepts the second draft and discounts it, crediting the net amount to the exporter’s account. The bank has now created a banker’s acceptance that can be sold in the highly liquid acceptance market, provided the bank’s reputation is solid. When payment is received from the importer, the bank applies the proceeds towards its own acceptance, which will be presented for payment if sold in the market. Should the drawee default, the bank has recourse to the drawer and can demand payment from that source.

## **FORFAITING**

Forfaiting is basically nonrecourse financing of receivables, similar to factoring. However, although a factor normally purchases a company’s short-term receivables, a forfait bank purchases notes that are long-term receivables with maximum maturities of eight years. The forfaiting bank has no recourse to the seller of the

goods, but gets the notes at a substantial discount in exchange for cash. Zurich and Vienna are the centers of forfaiting. Many large banks, including U.S. institutions, provide forfaiting through either their branches or specialized subsidiaries in these cities.

Forfaiting is used when government export credits or credit guarantees are not available or when a seller does not extend long-term credits to areas such as Eastern Europe. Forfaiting is also an important method of financing for small and medium-sized companies because it enables them to engage in transactions that would normally exceed their financial capabilities. By using forfaiting, small and medium-sized concerns can immediately sell their long-term receivables without recourse.

Forfaiting presents all of the risks associated with factoring, along with the risks associated with the long-term nature of purchased receivables. The examiner should review the bank’s forfaiting activities carefully to determine whether long-term receivables have been purchased from countries prone to periodic political or economic turmoil and the resulting fluctuations in exchange rates.

## **U.S. AND FOREIGN RECEIVABLES GUARANTEE AND INSURANCE PLANS**

To reduce credit, political, and other risks associated with foreign receivables financing, banks may avail themselves of a variety of guarantee and insurance plans, both public and private, that are available in many countries. Because of the complexity of the numerous plans available, an examiner must frequently rely on the technical knowledge of the staff in a bank’s international division who handle these transactions. Nevertheless, the examiner should know the risk coverage and claim adjustment provisions of the major plans. Often a bank’s experience with its receivables insurance and guarantee plans is indicative of its effectiveness and of whether the bank has properly met its responsibilities under the programs.

## **Export-Import Bank of the United States**

The Export-Import Bank of the United States (Eximbank) issues to commercial banks, for a

fee, guarantees of payment for foreign receivables that the bank purchases from exporters, generally without recourse to the exporter. The maturities of the receivables range from 181 days to over five years. Generally, the foreign buyer must make a cash payment, either before or upon delivery, of at least 10 percent of the invoice value, and the amount of receivables purchased by the bank without recourse to the exporter normally cannot exceed 90 percent of the financed portion of the sale (invoice amount less cash payment). This guarantee covers political risks, such as inconvertibility of foreign currencies into U.S. dollars, governmental actions preventing importation of goods, war, civil strife, expropriation, and confiscation by government action. Commercial risks, basically the credit risk of the foreign purchaser, usually are covered from six months to five years.

## Foreign Credit Insurance Association

The Foreign Credit Insurance Association (FCIA) is an association of leading marine, property, and casualty insurance companies. In cooperation with Eximbank, FCIA offers a comprehensive selection of credit insurance policies that protect policyholders against loss from failure to receive payment from foreign buyers.

FCIA coverage protects the exporter against the failure of the buyer to pay dollar obligations for commercial or political reasons; enables the exporter to offer foreign buyers competitive terms of payment; supports the exporter's prudent penetration of higher risk foreign markets; and gives the exporter greater liquidity and flexibility in administering a foreign receivables portfolio. The FCIA does not itself finance export sales. However, the exporter who insures account receivables against commercial and political risks is usually able to obtain financing from commercial banks and other lending institutions at lower rates and on more liberal terms than would otherwise be possible by assigning the proceeds of the FCIA insurance to the lenders.

Comprehensive FCIA policies protect exporters against nonpayment of receivables due to unforeseeable commercial and political occurrences. Commercial risks covered include insolvency or protracted default, which may be caused by economic deterioration in the buyer's market area, shifts in demand, unanticipated

competition, tariffs, or technical changes. Political risk coverage applies to defaults due to government action, such as currency inconvertibility, expropriation, and cancellation of import license, and to political disturbances, such as war, revolution, and insurrection.

FCIA generally offers four basic types of policies covering political and commercial risks:

- Short-term policies covering shipments normally sold on terms up to 180 days. The usual policy covers 100 percent of political risks and 90 percent of any losses from commercial risk.
- Medium-term policies insuring transactions from six months to five years. FCIA covers up to 100 percent of political risks and 90 percent of commercial risks, with the remainder retained by the exporter.
- Combined short-term/medium-term policies for sales that pass through distributors before reaching final buyers.
- Master policies that include the basic insurance features of the previous policies plus discretionary and deductible provisions. Under a master policy, usually only for short-term transactions, exporters may obtain FCIA authority to grant insured credit up to a certain amount without seeking prior approval. The deductible provision, used only for commercial risks and not political risks, requires the exporter to assume a fixed amount of the first loss on total debts.

(Source: *Washington Agencies That Help to Finance Foreign Trade*, seventh edition, Bankers Trust Company, New York.)

## Other Insurers

Numerous other private and governmental institutions, both in the United States and overseas, guarantee or insure risks assumed by commercial banks financing foreign receivables. Some examples of these institutions in other countries are the Export Credits Guarantee Department (ECGD) in the United Kingdom, COFACE in France, and HERMES in Germany.

In the United States, the Overseas Private Investment Corporation (OPIC), a corporation wholly owned by the U.S. government, offers insurance against the political risks of inconvertibility, expropriation, war, revolution, and insur-

rection and guarantees the repayment of private U.S. loans for U.S. citizens, U.S. concerns that are substantially and beneficially U.S.-owned,

and foreign concerns that are at least 95 percent owned by U.S. individuals or entities.

# International—Financing Foreign Receivables

## Examination Objectives

Effective date May 1996

Section 7050.2

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1. To determine if the policies, practices, procedures, and internal controls for the financing of foreign receivables are adequate.
2. To determine if bank officers are operating in conformance with established bank guidelines.
3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it relates to the financing of foreign receivables.
5. To determine compliance with laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

# International—Financing Foreign Receivables Examination Procedures

Effective date November 2003

## Section 7050.3

1. If selected for implementation, complete or update the international—financing foreign receivables section of the internal control questionnaire.
  2. Determine the scope of the examination on the basis of the evaluation of internal controls and the work performed by internal or external auditors.
  3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest reviews done by internal and external auditors from the examiner assigned to the audit review, and determine if appropriate corrections have been made.
  4. Obtain trial balances of applicable customer liability records.
    - a. Reconcile balances to department controls and the general ledger.
    - b. Review reconciling items for reasonableness.
  5. Using an appropriate technique, select borrowers for examination.
  6. Prepare examiners' credit line cards to include—
    - a. customers' aggregate foreign receivables—financing liability and
    - b. debt instruments aggregating customers' total outstanding liability.
  7. Obtain the following information:
    - a. past-due, nonaccrual, and reduced-rate loans, advances, and acceptances
    - b. loans whose terms have been modified by a reduction in the interest rate or the principal payment or by a deferral of interest or principal
    - c. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
    - d. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
    - e. loan commitments and other contingent liabilities
    - f. loans to principal shareholders, officers, and directors and to their related interests (indicate which officers are considered executive officers)
  8. Review the information received and perform the following:
    - a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.* Perform procedures in step 7a of section 7030.3, "International—Loans and Current Account Advances: Examination Procedures."
    - b. *Miscellaneous loan-debit and credit-suspense accounts.*
      - Discuss with management any large or old items.
      - Perform additional procedures as considered appropriate.
- g. reports on the indebtedness of executive officers and principal shareholders and their related interests to correspondent banks
  - h. a list of correspondent banks
  - i. miscellaneous loan-debit and credit-suspense accounts
  - j. Interagency Country Exposure Review Committee determinations
  - k. criticized Shared National Credits (applicable international credits)
  - l. loans considered "problem loans" by management
  - m. background information on directors, executive officers, principal shareholders, and their related interests
  - n. specific guidelines in the lending policy governing the financing of foreign receivables
  - o. current lending authorities of officers and lending committee (or committees)
  - p. the current interest-rate structure
  - q. any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee
  - r. reports furnished to the loan and discount committee or any similar committee
  - s. relevant reports furnished to the board of directors
  - t. loans classified during the previous examination



- c. *Loan commitments and other contingent liabilities.* Analyze the commitments and contingent liabilities of the obligors together with the combined amounts of their current loan balances.
- d. *Loans criticized during the previous examination.* Determine disposition of loans so classified by transcribing the current balance and payment status, or the date the loan was repaid and the source of repayment.
- Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank or as a result of a participation, sale, or swap with another lending institution.
  - If repayment was a result of a participation, sale, or swap, refer to step 7a of “International—Loans and Current Account Advances: Examination Procedures,” section 7030.3, for the appropriate examination procedures.
- e. *Shared National Credits.*
- Compare the schedule of foreign receivables financed included in the uniform review of Shared National Credits Program with the listing of credits selected for review to determine which loans in the sample are portions of Shared National Credits.
  - For each loan so identified, transcribe appropriate information from the schedule to line cards. No further examination procedures are necessary in this area.
- f. *Interagency Country Exposure Review Committee credits.* Identify any credits that were selected for review that are criticized for transfer-risk reasons by the Interagency Country Exposure Review Committee.
9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.
10. Prepare credit line cards for any loan not in the sample that, on the basis of information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to international cash accounts, overdrafts, and other loan areas, and together
- decide who will review the borrowing relationship. Pass or retain completed credit line cards.
12. Prepare collateral line cards for all borrowers selected in the preceding steps.
13. Obtain credit files for all borrowers for whom examiner credit line cards were prepared, and complete credit line cards, where appropriate. To analyze foreign receivables financed, perform the following procedures:
- a. Analyze the customers’ balance sheets and profit-and-loss figures as shown in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
  - b. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
  - c. Review supporting information for the major balance-sheet items and the techniques used in consolidation, determine the primary sources of repayment, and evaluate their adequacy.
  - d. Determine compliance with provisions of loan agreements.
  - e. Review digests of officers’ memoranda, mercantile reports, credit checks, and correspondence to determine the existence of any problems that might deter the contractual repayment program.
  - f. Obtain the following information:
    - *Open-account financing.*
      - whether the shipment is directed to third parties or branches and subsidiaries of the borrower
      - the financial strength and trustworthiness of the overseas buyer
      - the extent of foreign-exchange control and the availability of exchange for the importer to effect payment
      - the bank’s past experience in dealing with the borrower who sells on open account
    - *Sales on consignment.*
      - whether the shipment is directed to third parties or branches and subsidiaries of the obligor
      - the financial strength and trustworthiness of the foreign consignee
      - the responsibilities of the foreign sales agent, overseas representa-

- the extent of foreign-exchange control and the availability of exchange for that type of transaction in the country of destination
- whether the borrower's goods, without a definite buyer, are consigned abroad in the name of the borrower's bank or a foreign bank
- whether the goods being shipped are assigned to a responsible warehouseman
- any arrangements that have been made whereby the selling agent negotiates for the sale of the goods
- the regulations in the country of destination regarding the return of unsold consigned goods to the country of origin
- the bank's past experience in dealing with the borrower who sells on consignment
- *Advances against collections.*
  - the relationship between the amount collected in a month on the collections pledged as collateral and the borrower's credit limit
  - the tenor of sight drafts—a stated number of days after sight or a stated number of days after the date of the draft
  - instructions regarding delivery of documents against payment (D/P) or documents against acceptance (D/A)
  - whether amounts advanced against collections are within the percentage of advance limitation established
  - aging of drafts (collections)
  - ineligible drawees, including house bills
  - concentrations of drawees
  - financial strength of drawees
  - unusual situations such as disputes, nonacceptance of goods, and possession of goods without payment
  - dishonor and protest instructions
  - any special instructions
  - the extent of foreign-exchange controls and the availability of exchange for that type of transaction in the country of destination
- the bank's experience in dealing with the borrower who receives advances against collections
- *Discounted trade acceptances.*
  - the relationship between the amount collected in a month on the trade acceptances discounted and the borrower's credit limit
  - whether the bank discounted the trade acceptance with or without recourse
  - whether the borrower retains a percentage of the trade acceptance endorsed to the bank
  - aging of trade acceptances
  - ineligible drawees, including house bills
  - concentrations of drawees
  - financial strength of the drawees
  - unusual situations, such as disputes, nonacceptance of goods, and possession of goods without payment
  - dishonor and protest instructions
  - any special instructions
  - the extent of foreign-exchange controls and the availability of exchange for that type of transaction in the country of destination
  - the bank's experience in dealing with the borrower for whom its trade acceptances are discounted by the bank
- *Banker's-acceptance financing.*
  - the relationship between the amount collected from the foreign buyer in a month and the borrower's credit limit
  - whether the discounted draft drawn by the exporter (customer) on the exporter's bank has the same tenor as the draft addressed to the foreign buyer
  - the procedures for applying payment received from the foreign buyer to pay the bank's own acceptance
  - aging of time drafts drawn on the importer (drawee)
  - ineligible foreign buyers (drawees), including house bills
  - concentrations of foreign buyers (drawees)
  - financial strength of the foreign buyers (drawees)

- disputes, nonacceptance of goods, and possession of goods without payment
- dishonor and protest instructions
- any special instructions
- the extent of foreign-exchange control and the availability of exchange for that type of transaction in the country of destination
- the bank's experience in dealing with the borrower
- *Factoring.*
  - the extent the factor “guarantees” letters of credit opened by the bank in favor of overseas suppliers
  - whether the title documents on import transactions are consigned to or endorsed over to the factor
  - whether the importer who receives goods under trust receipt agrees to hold them in trust for the factor
  - whether the imported goods held under warehouse receipt are stored in an independent warehouse for the account of the factor
  - whether usance letters of credit are paid to the bank by the factor at maturity, and whether the resulting acceptances are charged to the bank customer's account for payment to the factor when due
  - whether the factor borrows from the bank or creates a banker's acceptance pending payment of accounts receivable resulting from the sale of goods imported under letters of credit
  - the financial strength of the importer for whom the bank opened the letter of credit
  - any disputes, nonacceptance of goods, and possession of goods without payment
  - the bank's experience in dealing with the factor
- *Forfeiting.*
  - agings of debtor accounts purchased
  - ineligible debtor accounts purchased, including affiliate receivables, if any
  - concentration of debtor accounts purchased
  - the adequacy of the bank's credit investigation before approving the sale (or signing of a sales contract) creating a receivable
- the financial strength of the debtor accounts purchased
- the capability of the exporter from whom receivables were purchased to provide any required after-sales service and to honor warranties
- disputes and returns
- the extent of foreign exchange restrictions, availability of exchange, and country risk involved that could jeopardize collection of receivables purchased
- the bank's experience in dealing with both the debtors and the exporter
- *U.S. and foreign receivables guarantee and insurance plans.* Determine whether foreign receivables coverage by FCIA, Eximbank, or other insurance or guarantee programs is sufficient, adequately identifies risks, and is consistent with established limits.
- g. Analyze secondary support offered by guarantors and endorsers.
- h. Determine compliance with the bank's established international loan policy.
- 14. For loans in the sample, check the central liability file on borrowers indebted above the cutoff line or borrowers displaying credit weaknesses or suspected of having additional liability in other loan areas.
- 15. Transcribe significant liability and other information of officers, principals, and affiliations of appropriate borrowers contained in the sample. Cross-reference line cards to borrowers, where appropriate.
- 16. Determine compliance with laws and regulations pertaining to financing foreign receivables by performing the following steps.
  - a. *Lending limits.* Determine the bank's lending limit as prescribed by state law, and note any exceptions.
  - b. *Section 23A, Relations with Affiliates (12 USC 371c), and section 23B, Restrictions on Transactions with Affiliates (12 USC 371c-1), of the Federal Reserve Act, and the Board's Regulation W.* Perform procedures in step 15b of “International—Loans and Current Account Advances: Examination Procedures,” section 7030.3.
  - c. *18 USC 215, Receipt of Commission or*

*Gift for Procuring Loans.*

- While examining foreign receivables financing, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
  - Investigate any such suspected irregularities.
- d. *Federal Election Campaign Act (2 USC 441b), Political Contributions.*
- Determine the existence of any loans in connection with any political campaigns.
  - Review each such credit to determine whether it is made in accordance with applicable banking laws and in the ordinary course of business.
- e. *12 USC 1972 and Regulation Y (12 CFR 225.7), Tie-In Provisions and Exceptions.* Determine whether any credit extension is conditioned upon—
- obtaining or providing any additional credit, property, or service from or to the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service, or
  - the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit
- f. *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests, and Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)), as amended by the Garn–St Germain Depository Institutions Act of 1982, Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.* Perform the Regulation O procedures of “International—Loans and Current Account Advances: Examination Procedures,” section 7030.3.
- g. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103), Retention of Credit Files.* Review the operating procedures and credit file documentation, and determine if the bank retains records of each extension of credit over \$10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date thereof. (Loans secured by an interest in real property are exempt.)
17. Perform the appropriate procedural steps in “Concentrations of Credit: Examination Procedures,” section 2050.3.
18. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
- a. delinquent loans;
  - b. loans not supported by current and complete financial information;
  - c. loans on which documentation is deficient;
  - d. loans with credit weaknesses;
  - e. inadequately collateralized loans;
  - f. criticized loans, including supporting commentaries;
  - g. concentrations of credit;
  - h. extensions of credit to major shareholders, officers, and directors and to their related interests;
  - i. violations of laws and regulations; and
  - j. other matters regarding the condition of the department.
19. Evaluate the bank for—
- a. the adequacy of written policies relating to financing foreign receivables;
  - b. the manner in which bank officers are operating in conformance with established policy;
  - c. adverse trends in those sections of the international sector of the bank concerned with financing foreign receivables;
  - d. the accuracy and completeness of the schedules obtained from “International—Loan Portfolio Management,” section 7020.3;
  - e. recommended corrective action when policies, practices, or procedures are deficient;
  - f. the competency of departmental management; and
  - g. other matters of significance.
20. Update the workpapers with any information that will facilitate future examinations.

# International—Financing Foreign Receivables Internal Control Questionnaire

Effective date March 1984

Section 7050.4

Review the bank's internal controls, policies, practices, and procedures regarding foreign receivables financing. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

## POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written foreign receivables financing policies that:
  - a. Establish procedures for reviewing financing applications?
  - b. Establish standards for determining credit lines?
  - c. Establish standards for determining the percentage of advances made against acceptable collections (receivables)?
  - d. Define acceptable receivables (collections)?
  - e. Establish minimum requirements for verification of borrower's receivables (collections)?
  - f. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are foreign receivables financing policies reviewed at least annually to determine if they are compatible with changing market conditions?

## ACCOUNTING RECORDS

- \*3. Is the preparation and posting of subsidiary records performed or adequately reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
- \*4. Are subsidiary records reconciled, at least monthly, with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle foreign receivables financing?

5. Are inquiries regarding foreign receivables financing loan balances received and investigated by persons who do not normally process documents, handle settlements, or post records?
- \*6. Are bookkeeping adjustments checked and approved by an appropriate officer?
- \*7. Is a daily record maintained summarizing transaction details, i.e., loans made, payments received, and interest collected to support applicable general ledger entries?
- \*8. Are frequent debt instrument and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record loan transactions?

## DOCUMENTATION

9. Are terms, dates, weights, description of the merchandise, etc., shown on invoices, shipping documents, trust receipts, and bills of lading scrutinized for differences?
10. Are procedures in effect to determine if the signatures shown on the above documents are authentic?
11. Are payments received from customers scrutinized for differences in invoice dates, numbers, terms, etc.?

## LOAN INTEREST

- \*12. Is the preparation and posting of loan interest records performed or adequately reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
13. Are independent interest computations made and compared or adequately tested to initial loan interest records by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?

## COLLATERAL

- \*14. Does the bank record on a timely basis a first lien on assigned foreign receivables for each borrower?

15. Do loans granted on the security of the foreign receivables also have an assignment of the inventory?
16. Does the bank verify the borrower's receivables or require independent verification on a periodic basis?
17. Does the bank require the borrower to provide aged receivables schedules on a periodic basis?
18. Are underlying bills of lading covering shipments either to the order of the shipper or blank endorsed to the order of the bank rather than the foreign buyer?
19. Are the shipments being financed covered by adequate insurance?
- U.S. banks forwarded directly to the bank and not through the exporter?
30. If the exporter accepts importer (drawee) payments directly, are controls established or audits of exporter's books conducted (if so, explain briefly)?
31. Are employees handling collections periodically rotated, without advance notification, to other banking duties?
- \*32. Is the employee handling collection proceeds required to apply them to the borrower's advance on the same business day that payment is received?
33. Is the disposition of each collection noted on the register so that verification of disposition can be made?
- \*34. Has a regular policy of following procedures been established for sending tracers and inquiries on unpaid collections in the hands of correspondents?
- \*35. Should the foreign drawee refuse to honor the draft, are instructions clear as to what actions should be taken by the collecting bank?
36. In the event of non-payment of the collection, is the borrower promptly notified by the bank?
- \*37. Are collections against which advances have been made or trade acceptances discounted distinctly segregated from ordinary collection items?
- \*38. Are collections above maintained under memorandum control and is the control balanced regularly?
- \*39. Are collections against which advances have been made or trade acceptances discounted booked by persons other than employees handling those items?
- \*40. Are collections carried over to the next business day adequately secured?
41. Does the customer for whom trade acceptances were discounted know whether they were purchased with or without recourse to that customer?
- \*42. Do all parties, i.e., the seller (exporter), importer (buyer), and banks, clearly understand whether interest, discount, and collection charges are to be absorbed by the seller or paid by the importer?

### ADVANCES AGAINST COLLECTIONS AND DISCOUNTED TRADE ACCEPTANCES

20. Are permanent registers kept for foreign collections against which advances were made or trade acceptances discounted?
21. Are all collections indexed in a collection register?
22. Do these registers furnish a complete history of the origin and final disposition of each collection against which advances were made or trade acceptances discounted?
23. Are receipts issued to loan customers for all collections received from them?
24. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?
- \*25. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collections?
26. Is a daily record maintained showing the various collections which have been paid and credited to the borrower's advance?
- \*27. Are proceeds of paid collections credited to the correct customer's advance?
28. Is an itemized daily summary made of all interest charged and received from the exporter or importer (drawee) indicating underlying collection numbers and amounts?
29. Are payments collected from importers (drawees) by foreign banks or branches of

### FACTORING

43. Has the bank properly surrendered the

- shipping documents to the factor either through endorsement or consignment?
- \*44. Do bank advances or banker's acceptances to the factor in payment of sight or time draft coincide with the expected payment of the accounts receivable by the ultimate customer?

### FOREIGN CREDIT INSURANCE ASSOCIATION INSURANCE

45. Is the bank aware of risks not covered under its FCIA insurance?
46. Does the bank monitor whether the borrower exceeded its FCIA established credit limits?
47. Does the bank monitor whether the borrower properly assigned the proceeds of its FCIA insurance to the bank?
48. Is the bank aware whether the FCIA insurance is on either "simple notice" or a "special assignment" basis?
49. Does the bank retain recourse to the exporter under its FCIA arrangement?
50. Has the bank reported delinquencies to FCIA in accordance with its agreement with the Association?
51. If default occurs, does the bank file a proper claim with FCIA?

### EXPORT-IMPORT BANK OF THE UNITED STATES

52. Does the bank, financing under Eximbank arrangements, have properly executed

Eximbank guarantees or commitments covering transactions?

53. If the bank has discretionary authority from Eximbank, does it nevertheless inform Eximbank of each transaction thereunder?
54. If the bank has been issued an "equipment political risk guarantee" by Eximbank, does it have a written statement from the government of the country in which the equipment will be used indicating that it will permit the importation, use, and any subsequent exportation of the equipment?
55. Does the bank monitor whether loan agreements between applicable borrowers and the bank are acceptable to Eximbank?
56. Does the bank report delinquencies to Eximbank in a timely manner as specified in its agreement with that agency?
57. If default occurs, does the bank file a proper claim with Eximbank?

### CONCLUSION

58. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
59. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

One method of financing international trade is by the use of a banker's acceptance. This instrument may be used to finance all of the successive stages of the movement of goods through the channels of trade from the point of origin to the final destination.

A banker's acceptance is an order in the form of a time draft (also referred to as a bill of exchange or a usance draft) drawn by one party (the drawer) in favor of itself or another party (the payee), addressed to (drawn on) a bank (the drawee), and accepted by that bank to pay the holder a certain sum on or before a specified date. The bank's acceptance of this order from the drawer, by stamping "ACCEPTED" across the face of the draft and dating and signing the stamp, is a formal acknowledgment of the obligation and constitutes an unconditional promise by that bank to honor the time draft at maturity. The drawee bank creating the acceptance is primarily liable for the instrument while the payee, as first endorser, is secondarily liable for paying the holder in due course. If the drawee (acceptor) is other than a bank, the instrument is a trade acceptance, not a banker's acceptance.

Most banker's acceptances are used to finance trade transactions. Accordingly, acceptances are often created in connection with a letter of credit, although they may arise in connection with collection or open-account transactions. (See section 7080, "International—Letters of Credit.") In general, acceptance credit is considered self-liquidating in that it must provide the means for its own payment at maturity. To accomplish this, the acceptance must be based on a specific trade transaction in which goods are being shipped before entering the channels of trade. There should be satisfactory evidence to indicate that the draft, when created, is based on an actual shipment or storage and that, at maturity of the draft, the proceeds from the sale of the goods will be used to settle the draft. To a lesser extent, acceptances also finance the domestic shipment of goods and domestic or foreign storage of readily marketable staples.

The payee of the acceptance may hold an acceptance until maturity, discount it with his or her bank, or sell it in the acceptance market. When a bank discounts (purchases) its own acceptance for the payee, its "Customer's Liability on Acceptances" (asset) and "Bank's Liability on Acceptances" (liability) accounts are reduced, and the discounted acceptance is

recorded with other loans and discounts. If the accepting bank subsequently rediscounts (sells) the acceptance in the market, that acceptance is rebooked as "Customer's Liability on Acceptances" and "Bank's Liability on Acceptances," and the loan and discount accounts are reduced. Rediscounted acceptances are not considered borrowings. The customer's liability on acceptances is reduced by a customer's prepayment or anticipation of an acceptance outstanding. The bank's liability is not similarly reduced by an anticipation.

The established market for banker's acceptances in the United States is regulated by the Federal Reserve System. Federal Reserve Banks are authorized to discount or purchase eligible banker's acceptances subject to qualitative and quantitative limits, thus providing a source of liquidity to the selling banks. The creation of banker's acceptances is governed by section 13 of the Federal Reserve Act, which establishes criteria that must be met for the instrument to be eligible for either discount or purchase by a Federal Reserve Bank. The rules governing whether an acceptance meets the eligibility requirements for discount or purchase are important for two major reasons. First, acceptances meeting the conditions of eligibility are more readily salable in the market than acceptances that do not satisfy these conditions and, as such, provide a greater degree of liquidity for the accepting bank. Second, ineligible acceptances, unlike those that are eligible, are subject to reserve maintenance requirements, thus raising the cost to the borrower over that of an eligible acceptance. The examiner must be familiar with the criteria used for determining eligibility for discount or purchase by a Federal Reserve Bank.

Section 207 of the Bank Export Services Act (title II of P.L. 97-290), which amended section 13 of the Federal Reserve Act (12 USC 372), limits the aggregate amount of eligible banker's acceptances that may be created by a member bank to 150 percent (or 200 percent with the permission of the Board) of its paid-up and unimpaired capital stock and surplus. In addition, a member bank is prohibited from creating eligible banker's acceptances for any one person in the aggregate in excess of 10 percent of the institution's capital. Eligible banker's acceptances growing out of domestic transactions are not to exceed 50 percent of the aggregate of all eligible acceptances authorized for a member



bank. All of the foregoing limitations are also applicable to U.S. branches and agencies of foreign banks that are subject to reserve requirements under section 7 of the International Banking Act of 1978 (12 USC 3105).

Banker's acceptances as a source of financing and investment offer significant advantages to

borrowers, accepting banks, and investors alike. Over the years, a banker's acceptance has often been a cheaper financing vehicle than a loan since it is readily marketable, considered an important secondary reserve for the accepting bank, and a relatively secure investment to the investor because of its two-name backing.

# International—Banker's Acceptances

## Examination Objectives

Effective date May 1996

## Section 7060.2

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1. To determine if objectives, policies, practices, procedures, and internal controls for banker's acceptances are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function as it applies to banker's acceptances.
4. To evaluate the portfolio for documentation and collateral sufficiency, credit quality, and collectibility.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when objectives, policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations have been cited.

# International—Banker's Acceptances

## Examination Procedures

Effective date March 1984

## Section 7060.3

1. If selected for implementation, complete or update the banker's acceptance section of the Internal Control Questionnaire.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records and:
  - a. Reconcile balances to department controls and the general ledger.
  - b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination.
6. Prepare credit line cards to include:
  - a. Customer's aggregate banker's acceptance liability.
  - b. Banker's acceptances aggregating the customer's total liability, listing:
    - Current balance of the acceptance.
      - Indicate any prepayments (anticipations) and portions sold under participation certificate.
    - Date the acceptance was created.
    - Tenor of the acceptance (give exact maturity date, if specified).
    - Type of acceptance.
      - Import.
      - Export.
      - Third country shipment.
      - Domestic shipment.
      - Storage.
      - To create dollar exchange.
      - Working capital and/or pre-export.
      - Refinancing of sight letters of credit.
      - Current status of the acceptance.
7. Obtain the following information, if applicable to banker's acceptances, which may necessitate inclusion of additional customers (borrowers) in the credit review:
  - a. Delinquencies.
  - b. Participations purchased and sold (including syndicate participations).
    - Acceptance participations sold.
    - Acceptance pool participations (borrowings).
  - c. Loan commitments and other contingent liabilities.
  - d. Extensions of credit to major stockholders, officers, directors and their interests.
  - e. Extensions of credit to executive officers, directors and their interests of correspondent banks.
  - f. Miscellaneous loan debit and credit suspense accounts.
  - g. Criticized shared national credits (applicable foreign credits).
  - h. Interagency Country Exposure Review Committee determinations.
  - i. Extensions of credit considered "problem loans" by management.
  - j. Information on directors, executive officers, principal shareholders and their interests.
  - k. Specific guidelines in the lending policy pertaining to banker's acceptances.
    - l. Each officer's current lending authority.
    - m. The current fee structure.
    - n. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
    - o. Reports furnished to the Loan and Discount Committee or any similar committee.
    - p. Reports furnished to the directorate.
    - q. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
  - a. Participations purchased and sold:
    - Test participation certificates and records and determine that the parties share in the risks and contractual payments according to the agreement.
    - Determine that the books and records of the bank properly reflect the bank's liability.
    - Investigate any participations sold immediately prior to the date of examination to determine if any were sold to

- avoid possible criticism during the examination.
- b. Loan commitments (including acceptance commitments) and contingent liabilities.
    - Analyze the commitment or contingent liability if the borrower has been advised of the commitment together with the combined amounts of the current loan balance, if any.
  - c. Banker's acceptances created for officers and directors of other banks:
    - Investigate any circumstances which indicate preferential treatment.
  - d. Miscellaneous loan debit and credit suspense accounts:
    - Discuss with management any large or old items relating to banker's acceptances.
  - e. Shared national credits:
    - Compare the schedule of banker's acceptances included in the Uniform Review of National Credits Program to the sample selection to determine which banker's acceptances in the sample are portions of shared national credits (including applicable foreign credits).
    - For each banker's acceptance so identified, transcribe appropriate information from the schedule to line sheets and return the schedule. No further examination procedures are necessary for this area.
  - f. Cross-border lending:
    - Review credit risk without regard to cross-border considerations which will be analyzed separately. No further examination procedures are necessary in this area.
  - g. Loans criticized during the previous examination:
    - Determine disposition of banker's acceptances so criticized by transcribing:
      - current balance and payment status, or
      - date the banker's acceptance was repaid and the source of repayment.
  9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.
  10. Prepare a credit line card for any banker's acceptance not in the sample which, based on information derived from the above schedules, requires an in-depth review.
  11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and other loan areas and, together, decide who will review the borrowing relationship. Pass or retain completed credit line cards.
  12. Obtain credit files for all borrowers for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the loans, perform the following procedures:
    - a. Analyze balance sheet and profit and loss figures as shown in current and preceding financial statements, and determine the existence of any unfavorable trends.
    - b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
    - c. Review components of the balance sheet as shown in the current financial statements and determine the reasonableness of each item as it relates to the total financial structure.
    - d. Review supporting information for the major balance sheet items and the techniques used in consolidation and determine the primary sources of repayment and evaluate their adequacy.
    - e. Review compliance with the provisions of acceptance agreements.
    - f. Review the digest of officer's memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
    - g. Relate any collateral values to outstanding debt, including margin and cash collateral deposits.
    - h. Compare fees charged to the fee schedule(s) and determine that the terms are within established guidelines.
    - i. Compare the amount of banker's acceptances outstanding with the lending officer's authority.
    - j. Analyze secondary support afforded by guarantors.
    - k. Ascertain compliance with the bank's established banker's acceptance policy.

13. For banker's acceptances in the sample, check the central liability file on borrowers indebted above the cutoff and on borrowers displaying credit weaknesses or suspected of having additional liability in loan areas.
14. Transcribe significant liability and other information on officers, principals and affiliations of appropriate obligors contained in the sample. Cross-reference line sheets to borrowers, where appropriate.
15. Determine compliance with laws, regulations, and eligibility requirements regarding banker's acceptance financing by performing the following steps:
  - a. Determine bank compliance with state limits or the aggregate amount of acceptances that may be created for any one customer, and acceptances created to furnish dollar exchange.
  - b. Determine compliance with stipulated aggregate liability limitations on acceptances outstanding. (See Federal Reserve Act, section 13 for single person and aggregate limitation provisions.)
  - c. Determine which acceptances are ineligible and therefore subject to loan limitations imposed by state law. In general, an eligible banker's acceptance is one which must arise out of a transaction described in section 13 of the Federal Reserve Act. For details of eligibility requirements, refer to the operating provisions of the Federal Open Market Committee and interpretations of the Board of Governors of the Federal Reserve System. Eligibility can be determined by reviewing documentary evidence detailing the nature of the transaction underlying the credit extended. This evidence may be correspondence, title documents or document transmittal letters which provide sufficient detail to judge eligibility according to established criteria. Details provided should cover:
    - Value of merchandise.
    - Description of merchandise.
    - Origin and destination of shipment.
    - Date of shipment.
    - Certification that the merchandise is not being financed elsewhere.
  - d. Ensure that all of the bank's own acceptances discounted that are not rediscounted, whether eligible or ineligible, are booked as loans and thus subject to the loan limitations imposed by state law.
- e. Determine if state law imposes loan limitations on eligible acceptances of other banks purchased.
- f. Review acceptance participation agreements to determine if the purchaser has recourse to the bank in the event of default by the account party, in which case the liability would be considered a borrowing. Such borrowings may be subject to limitations on indebtedness of member banks imposed by state law.
- g. Determine acceptances issued on behalf of an affiliate which constitute extensions of credit under section 23A of the Federal Reserve Act.
16. Perform appropriate procedural steps in the Concentration of Credits section.
17. Discuss with appropriate officer and prepare summaries in appropriate report form of:
  - a. Violations of laws and regulations.
  - b. Acceptances not supported by current and complete financial information.
  - c. Acceptances on which collateral documentation is deficient.
  - d. Concentrations of credit.
  - e. Criticized loans.
  - f. Inadequately collateralized acceptances, if applicable.
  - g. Banker's acceptances created for major shareholders, employees, officers, directors and related interests.
  - h. Banker's acceptances which, for any other reason, are questionable as to quality and ultimate collection.
18. Evaluate the bank with respect to:
  - a. The adequacy of written policies relating to banker's acceptances.
  - b. The manner in which bank officers are operating in conformance with established policy.
  - c. Adverse trends within the banker's acceptance department.
  - d. The accuracy and completeness of the schedules obtained.
  - e. Internal control deficiencies or exceptions.
  - f. Recommended corrective action when policies, practices or procedures are deficient.
  - g. The quality of departmental management.
  - h. Other matters of significance.
19. Update the workpapers with any information that will facilitate future examinations.

# International—Banker's Acceptances

## Internal Control Questionnaire

Effective date June 1985

## Section 7060.4

Review the bank's internal controls, policies, practices and procedures for creating and servicing banker's acceptances. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written banker's acceptance policies that:
  - a. Establish procedures for reviewing banker's acceptance applications?
  - b. Define qualified customers?
  - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are banker's acceptance policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

3. Is the preparation and posting of subsidiary banker's acceptance records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
4. Are the subsidiary banker's acceptance records balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle acceptances and post records?
5. Are acceptance delinquencies prepared for and reviewed by management on a timely basis?
6. Are inquiries about acceptance balances received and investigated by persons who do not normally handle settlements or post records?
7. Are bookkeeping adjustments checked and approved by an appropriate officer?
8. Is a daily record maintained summarizing acceptance transactions details, i.e., bankers acceptances created, payments received and

fees collected, to support applicable general ledger account entries?

9. Are acceptances of other banks that have been purchased in the open market segregated on the bank's records from the bank's own acceptances created?
10. Are prepayments (anticipations) on outstanding banker's acceptances netted against the appropriate asset account "Customer Liability for Acceptances" (or loans and discounts, depending upon whether or not the bank has discounted its own acceptance), and do they continue to be shown as a liability "Bank's Liability on Acceptances"?
11. Are banker's acceptance record copies and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record acceptance transactions?

### FEES

12. Is the preparation and posting of fees and discounts performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
13. Are any independent fee and discount computations made and compared or adequately tested to initial fee and discount records by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?

### COLLATERAL

See International—Loans and Current Account Advances section.

### OTHER

14. Are acceptance record copies, own acceptances discounted (purchased), and acceptances of other banks purchased safeguarded during banking hours and locked in the vault overnight?

15. Are blank (pre-signed) customer drafts properly safeguarded?
16. Are any acceptance fee rebates approved by an officer?
17. Does the bank have an internal review system that:
- Re-examines collateral and supporting documentation held for negotiability and proper assignment?
  - Test checks the values assigned to collateral at frequent intervals?
  - Determines that lending officers are periodically advised of maturing banker's acceptances or acceptance lines.
18. Does the bank's acceptance filing system provide for the identification of each acceptance, e.g., by consecutive numbering and applicable letter of credit, to provide a proper audit trail?

## CONCLUSION

19. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
20. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

U.S. banks and their overseas branches maintain interest-bearing time deposits, known as “due from banks—time,” with foreign banks and overseas branches of U.S. banks. These assets may also be referred to as placements, placings, interbank placements (deposits), call money, or redeposits. Due from banks—time deposits have maturities ranging from one day to several months or years. Certain examination procedures, internal control considerations, and verification procedures in the domestic due from banks section (section 2010) are relevant to international due from banks—time. However, the specialized nature of foreign deposits necessitates additional examination procedures.

Constraints are placed on the amount member banks may deposit with domestic depository institutions. A member bank may not keep on deposit with any depository institution not having access to the Federal Reserve discount window more than 10 percent of its paid-in and unimpaired capital and surplus funds. State member banks may keep on deposit with foreign banks an amount exceeding that 10 percent limitation.

Due from banks—time deposit activities became important with the growth of the Eurodollar market. The bulk of due from banks—time deposits now consists of Eurodollars with smaller amounts in other Eurocurrencies. Other Eurocurrency time deposits are placed in substantially the same manner as Eurodollar deposits, but may be subject to differing exchange control regulations depending on the location of the office making the deposit.

Eurodollar deposits are sometimes linked with foreign-exchange transactions. As a result, the Eurocurrency deposit trader will frequently work closely with the foreign-exchange trader when making the deposit decision. Foreign-exchange brokers may act as intermediaries if warranted by market conditions, local customers, the size of the bank, or other factors.

Due from banks—time deposits are treated as deposits in the Report of Condition, but contain the same credit and country risks as loans or extensions of credit. Consequently, a prudently managed bank should place deposits only with other sound and well-managed banks. The deposit traders should be provided with a list of approved banks with which funds can be deposited up to specific limits. Due from banks—time deposits differ from other types of credit extensions because they often represent deposits of relatively short maturity, which normally receive first priority on repayment in case of insolvency. Nevertheless, as credit and transfer risk exists, exposure limits are to be established by credit officers and not by foreign-exchange or deposit traders. These limits must be reviewed regularly by credit officers, particularly during periods of money market uncertainty or rapidly changing economic and political conditions. Incoming confirmations of transactions from depository institutions must be carefully verified against bank records to protect against fraud and error. Similarly, a systematic follow-up on nonreceipt of incoming confirmations should be closely monitored.



# International—Due from Banks—Time

## Examination Objectives

Effective date May 1996

## Section 7070.2

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1. To determine if the policies, practices, procedures, and internal controls for due from banks—time (interbank placements and call money) are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine that all due from banks—time accounts are reasonably stated and represent funds on deposit with other banks.
4. To determine whether the bank evaluates the credit quality of banks with which time accounts are maintained.
5. To determine the scope and adequacy of the internal and external audit function as it applies to international due from banks—time.
6. To determine compliance with laws and regulations.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, rulings, or regulations have been cited.

# International—Due From Banks—Time Examination Procedures

Effective date March 1984

## Section 7070.3

1. If selected for implementation, complete or update the Due from Banks—Time (placement and call money) section of the Internal Control Questionnaire.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records pertaining to due from banks—time by currency and maturity and:
  - a. Reconcile balance to department controls and general ledger.
  - b. Review reconciling items for reasonableness.
5. Determine those due from banks—time deposits that are unconfirmed as of examination date and:
  - Determine why incoming matching confirmations are lacking.
  - Review the extent of follow-up procedures.
6. Using an appropriate technique, select deposit customers for examination.
7. Prepare credit line cards on the customers selected for review to include the following:
  - a. Name of bank and location.
  - b. Customer's aggregate due from bank—time liability.
  - c. For each due from bank—time deposit placement comprising the customer's total exposure to the bank, record the following information:
    - Amount.
    - Currency.
    - Inception date.
    - Value date.
    - Maturity date.
    - Interest rate.
8. Determine whether selected customers are:
  - a. Affiliates of the bank or other banks.
  - b. Banks and not finance companies or commercial borrowers.
9. Obtain and review the following information, if applicable:
  - a. Matured and unpaid due from banks—time deposits.
  - b. Miscellaneous loan debit and credit suspense accounts.
  - c. Interagency Country Exposure Review Committee determinations.
  - d. Due from banks—time deposit placements that are considered problem assets by management.
  - e. Specific guidelines in bank policy relating to due from banks—time.
  - f. A current listing of due from banks—time approved customer lines.
  - g. The current interest rate structure.
  - h. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
  - i. Reports furnished to the Board of Directors.
  - j. Due from banks—time deposit placements that were criticized during the previous examination.
  - k. A listing of due from banks—time deposits that were previously charged-off.
10. Transcribe or compare information from the above schedules to credit line cards where appropriate, and indicate any cancelled bank lines.
11. Prepare credit line cards for any due from bank—time not in the sample which, based on information derived from the above schedules, requires an in-depth review.
12. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and loan areas and decide who will review the borrowing relationship. Pass or retain completed credit line cards.
13. Obtain credit files for all borrowers for whom credit line cards were prepared and complete credit line cards where appropriate. To analyze due from banks—time, perform the following procedures:
  - a. Analyze balance sheet and profit and loss figures as shown in current and preceding financial statements, and determine

- the existence of any favorable or adverse trends.
- b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
  - c. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the customer's total financial structure.
  - d. Review supporting information for the major balance sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate their adequacy.
  - e. Compare each bank's balance sheet, profit and loss items and ratios with those of comparable banks in the same country to help identify banks which may be overextended.
  - f. Review compliance with provisions of due from banks—time deposit agreements.
  - g. Review digest of officers' memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
  - h. Compare interest rate(s) charged to the interest rate schedule(s), and determine that the terms are within established guidelines.
  - i. Compare the amount of due from banks—time deposits with:
    - Lending officer's authority.
    - Depositor's limit established by the bank.
  - j. Detail the major owners of the bank and whether there is any support by the government.
  - k. Ascertain compliance with established bank policy.
14. For banks in the sample, check the customer central liability reporting system for any other indebtedness.
  15. Transcribe significant liability and other information on officers, principals and affiliates of banks contained in the sample. Cross-reference line cards to banks (borrowers), where appropriate.
  16. Determine compliance with state laws and regulations pertaining to due from banks—time.
  17. Determine the existence of any concentration of time deposits with other banks. Include due from banks—demand (nostro), time deposits and any call money in computation. For concentrations exceeding 25 percent of the bank's capital structure, forward information to examiners assigned "Concentrations of Credit" for possible inclusion in the report of examination.
  18. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    - a. Matured and unpaid due from banks—time deposits.
    - b. Violations of laws and regulations.
    - c. Due from banks—time deposits not supported by current and complete financial information.
    - d. Due from banks—time deposits on which documentation is deficient.
    - e. Concentrations.
    - f. Criticized credits (portions applicable to due from banks—time deposits).
    - g. Due from banks—time deposits which, for any other reason, are questionable as to quality and ultimate repayment.
    - h. Other matters regarding the condition of the department.
  19. Evaluate the bank with respect to:
    - a. The adequacy of written policies relating to due from banks—time.
    - b. The manner in which bank officers are operating in conformance with established policy.
    - c. Adverse trends within the due from banks—time department.
    - d. The accuracy and completeness of the schedules.
    - e. Internal control deficiencies or exceptions.
    - f. Recommended corrective action when policies, practices or procedures are found to be deficient.
    - g. The quality of departmental management.
    - h. Other matters of significance.
  20. Update the workpapers with any information that will facilitate future examinations.

# International—Due From Banks—Time

## Internal Control Questionnaire

Effective date March 1984

## Section 7070.4

Review the bank's internal controls, policies, practices and procedures regarding due from banks—time. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies for international due from banks—time that:
  - a. Establish maximum limits of the aggregate amount of due from bank—time deposits for each:
    - The bank?
    - The currency of deposit?
    - The country of deposit?
  - b. Restrict due from bank—time deposits to only those customers for whom lines have been established?
  - c. Establish definite procedures for:
    - Balancing of accounts?
    - Holdover deals?
    - Rendering of reports to management, external auditors and regulating agencies?
    - Accounting cutoff deadlines?
    - Handling of interest?

### CERTIFICATES OF DEPOSIT

2. Are bank issued certificates of deposits safeguarded as other negotiable investment instruments?
3. Are safekeeping receipts for certificates of deposits issued, but held by others, checked to the original purchase order for accuracy?

### DEALING ROOM INSTRUCTIONS

(Although dealing room and instructions functions must be separate, often foreign exchange

and due from bank—time activities relating to those functions are combined.)

4. Are dealer slips and contract/confirmation sets relating to due from banks—time numbered sequentially and checked periodically?
5. Is a positions clerk present in the dealing room to maintain dealers' memoranda records of due from bank—time deposits?
6. Is due from banks—time "instructions" (operations) organizationally and physically separate from the foreign exchange dealers?
- \*7. Do good communications appear to exist between the dealing room and instructions to assure:
  - a. An effective working relationship with operations and management to ensure adequate control and management information?
  - b. Coordination with operations regarding correct delivery/settlement instructions?
- \*8. Does operations maintain all official accounting records relating to due from banks—time?
- \*9. Does operations:
  - a. Balance official records against dealing room memoranda records as scheduled by management?
  - b. Check confirmations for errors?
  - c. Receive, review and control dealer's slips?
  - d. Handle all payments and receipts?
- \*10. Are confirmations compared to the general ledger entries for accuracy?

### CONFIRMATIONS

- \*11. Does operations monitor follow-up on non-receipt of incoming confirmations?
- \*12. Are outgoing and incoming confirmations ever handled by dealers who initiate due from bank—time transactions?
- \*13. Does the bank check that there are no confirmation deals dated:
  - a. Prior to the bank's own due from bank—time deal dates?
  - b. After the bank's own due from bank—time deal dates?

## TESTING ARRANGEMENTS

(See the Wire Transfer section.)

## SIGNATURE BOOKS

- \*14. Are customer signature books updated with regard to those with whom regular business is transacted?
- \*15. Does the bank check signatures on incoming confirmations for authenticity? (Many banks do not check signatures on incoming confirmations.)
- \*16. Does the bank check signatures for deals with non-bank customers?
- \*17. Are banks that do not sign confirmations asked to confirm such practice in writing over an authorized signature?

## ACCOUNT RECORDS

- \*18. Are subsidiary records reconciled with the general ledger accounts and reconciling items adequately investigated by persons who do not post transactions to such records?
- 19. Is a due from foreign bank—time deposit trial balance prepared on a periodic basis (if so, indicate frequency \_\_\_\_\_)?
- 20. Is a daily reconciliation made of due from

bank—time deposit controls to the general ledger?

- 21. Are reconciliations reviewed by an officer independent of the reconciliation?

## OTHER

- 22. Are individual interest computations checked or adequately tested by persons independent of those functions?
- 23. Are accrual balances for due from banks—time verified periodically by an authorized official (if so, indicate frequency \_\_\_\_\_)?
- 24. Do all internal entries require the approval of appropriate officials?

## CONCLUSION

- 25. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
- 26. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

### INTRODUCTION

Letters of credit are the most widely used instrument to finance foreign transactions. The two major types of letters of credit are the commercial documentary letter of credit and the standby letter of credit.

### COMMERCIAL DOCUMENTARY LETTERS OF CREDIT

This type of letter of credit is used most commonly to finance a commercial contract for the shipment of goods from seller to buyer. A commercial documentary letter of credit is a letter addressed by a bank (issuing bank) on behalf of its customer, a buyer of merchandise (account party), to a seller (beneficiary) authorizing the seller to draw drafts up to a stipulated amount under specified terms. The beneficiary will be paid when the terms of the letter of credit are met and the required documents are submitted to the paying bank.

Generally, the issuance of letters of credit is governed by article 5 of the Uniform Commercial Code (UCC). However, if the credit is issued under New York law, the credit will be governed instead by the Uniform Customs and Practice for Documentary Credits (UCP). The parties may also stipulate that the UCP rather than the UCC applies. Letters of credit may also be governed by foreign law. Generally, letters of credit are—

- signed and in writing,
- in favor of a definite beneficiary,
- for a specific amount of money, and
- in a form clearly stating how payment to the beneficiary is to be made and under what conditions.

In addition, they are issued with a definite expiration date.

Commercial letters of credit are issued in either irrevocable or revocable form. Once the beneficiary receives an irrevocable letter of credit, it cannot be canceled or amended without the beneficiary's consent. Conversely, a revocable letter of credit can be canceled or

amended by the issuing bank at any time without notice to or consent from the customer or the beneficiary.

An irrevocable letter of credit constitutes a definite commitment by the issuing bank to pay, provided the beneficiary complies with the letter's terms and conditions. In contrast, the revocable credit is not truly a bank credit but serves as a device that provides the buyer and seller with a means of settling payments. Since a revocable credit can be canceled or changed without notice, the beneficiary should not rely on the credit but rather on the willingness and ability of the buyer to meet the terms of the underlying contract.

The letter of credit may be sent to the beneficiary directly by the issuing bank or through the issuing bank's correspondent (advising bank) located in the same place as the beneficiary. The advising bank gives notice of the issuance of a letter of credit without assuming any obligation to honor demands for payment. Advised letters of credit will bear a notation by the advising bank that it makes "no engagement" or words to that effect. An irrevocable advised letter of credit is, therefore, an undertaking to pay by the issuing bank, but not by the advising bank.

Some beneficiaries (sellers), particularly those not familiar with the issuing bank, request the buyer to have the irrevocable credit issued in the buyer's country and "confirmed" by a bank in the seller's country. Confirmed letters of credit are evidenced by the confirming bank's notation: "We undertake that all drafts drawn . . . will be honored by us" or similar words. The beneficiary of a confirmed credit has a definite commitment to pay from a bank in his or her country and need not be concerned with the willingness or ability of the issuing bank to pay. An advising bank may add its confirmation and be designated in the letter as the paying bank.

Payment terms of a letter of credit usually vary from sight to 180 days, although other terms are sometimes used. The letter will specify on which bank drafts are to be drawn. If the draft is drawn at sight, the bank will effect payment upon presentation of the draft, provided the terms of the credit have been met. If the draft is drawn on a time basis, the bank will accept the draft (by stamping "Accepted" on the face of the draft), which then can be held by the seller or the bank until maturity. Alternatively, the accepted draft can be sold or discounted.

(See section 7060, “International—Banker’s Acceptances.”)

Certain categories of commercial letters of credit, such as back-to-back and red clause credits, contain an element of risk, and banks should exercise caution in their negotiation. Similarly, deferred-payment letters of credit, which become direct assets and liabilities of a bank after presentation and receipt of the beneficiary’s documents, involve greater potential risk when coupled with the length of time the credit is outstanding.

A transferable letter of credit enables the original beneficiary to transfer the rights of payment to one or more beneficiaries. Frequently, the beneficiary is a middleman who does not own the goods at the time the letter of credit is issued. Thus, the beneficiary may seek to use the letter of credit to finance the acquisition of the goods. Under the UCP, a transferable letter of credit may be transferred only once unless otherwise stated.

A revolving letter of credit allows for monthly shipments with payments being either cumulative or noncumulative. In the case of cumulative credits, undrawn amounts carry over to future periods. However, most letters of credit are nonrevolving and are valid for one transaction. Since the maximum exposure under an irrevocable revolving credit can be large, most revolving credits are issued in revocable form.

Documentation is of paramount importance in all letter of credit transactions. The bank is required to examine all documents with care to determine that they conform to all of the terms and conditions of the letter of credit. Many letters of credit are part of continuous transactions, evolving from letters of credit to sight drafts or acceptances or to notes and advances covered by trust receipts or warehouse receipts. Ultimate repayment often depends on the eventual sale of the goods involved. Thus, the proper handling and accuracy of the documents required under the letter of credit is of primary concern.

## STANDBY LETTERS OF CREDIT

A standby letter of credit guarantees payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the bank’s customer). Although a standby letter of credit may arise from a commercial

transaction, it is not linked directly to the shipment of goods from seller to buyer. It may cover performance of a construction contract, serve as an assurance to a bank that the seller will honor his or her obligations under warranties, or relate to the performance of a purely monetary obligation, for example, when the credit is used to guarantee payment of commercial paper at maturity.

Under all letters of credit, the banker expects the customer to be financially able to meet his or her commitments. A banker’s payment under a commercial credit for the customer’s account is usually reimbursed immediately by the customer and does not become a loan. However, the bank makes payment on a standby letter of credit only when the customer, having defaulted on his or her primary obligation, is unable to reimburse it.

A standby letter of credit transaction involves greater potential risk for the issuing bank than a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of a standby letter of credit retains nothing of value to protect against loss, whereas a commercial documentary letter of credit provides the bank with title to the goods being shipped. To reduce the risk of a standby letter of credit, the issuing bank’s credit analysis of the account party should be equivalent to the analysis of a borrower in an ordinary loan situation.

The standby letter of credit transactions of state member banks are subject to the legal restrictions of Regulation H and section 23A of the Federal Reserve Act. For reporting purposes, standby letters of credit are shown as contingent liabilities in the issuer’s Report of Condition.

Under the revised capital/risk assets guidelines, banks now must allocate capital against standby letters of credit. See the capital adequacy guidelines of November 1995 for information concerning capital allocation requirements against standby letters of credit.

## ANTI-BOYCOTT REGULATIONS

The Export Administration Act of 1973 prohibits banks from taking or knowingly agreeing to take actions that support any boycott against a country friendly to the United States. Under anti-boycott regulations (which are issued by the Department of Commerce and enforced by the

Office of Anti-Boycott Compliance), U.S. banks are required to report letters of credit they receive that include illegal boycott terms or conditions and should establish an ongoing program to review all letters of credit. These regulations apply to both domestic and overseas branches of all U.S. banks.

The anti-boycott provisions prohibit banks from opening, negotiating, confirming, or paying international letters of credit that contain illegal terms or conditions. The improper language is most often seen in documentary letters of credit, sight reimbursements, and pass-on letters of credit, but may also appear in drafts and wire payments. Often, a bank's customer

may try to add improper language orally rather than in writing. Boycott language includes clauses or requirements such as—

- certification that the goods are not of a particular origin, such as Israeli or South African;
- certification that any supplier or provider of services does not appear on the Arab blacklist;
- the condition, “Do not negotiate with black-listed banks,” or words to that effect;
- a request not to ship goods on an Israeli carrier or on a vessel or carrier that calls at Israel en route to a boycotting country; and
- a request for a certificate stating the origin of the goods or the destination of the goods.



# International—Letters of Credit Examination Objectives

Effective date May 1996

## Section 7080.2

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1. To determine if objectives, policies, practices, procedures, and internal controls for letters of credit are adequate.
2. To determine whether bank officers are operating in conformance with established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To evaluate the portfolio for documentation and collateral sufficiency, credit quality, and collectibility.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when objectives, policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations are noted.

# International—Letters of Credit Examination Procedures

Effective date March 1984

## Section 7080.3

1. If selected for implementation, complete or update the Letters of Credit section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal and external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records and:
  - a. Reconcile balances to department controls and the general ledger.
  - b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select customers for examination.
6. Prepare examiners' credit line cards for each customer selected to include:
  - a. Total line available for letters of credit.
  - b. Total outstanding letters of credit.
    - Undrawn amount.
    - Date of issuance.
    - Expiration date of the credit.
    - Name of the beneficiary.
    - Tenor of the drafts to be drawn.
    - Purpose for the credit.
    - Issued or confirmed.
    - Revocable or irrevocable.
    - Negotiable or non-negotiable.
    - Revolving.
      - Cumulative or noncumulative.
    - Transferable.
    - Assignable.
    - Amendments.
    - Issued on behalf of domestic banks.
    - Application (with official approval) is on file and in agreement with letter of credit terms.
    - Bank's copy is initialed by the officer who signed the original letter of credit.
7. Obtain the following information if it is applicable to the letter of credit department.

Such information may necessitate inclusion of additional customers in the credit review.

  - a. Delinquencies.
  - b. Participations purchased and sold since the preceding examination (including syndicate participations).
  - c. Loan commitments and other contingent liabilities.
  - d. Letters of credit issued (or confirmed) for major shareholders, officers, directors and their related interests.
  - e. Letters of credit issued (or confirmed) for employees, officers and directors of other banks.
  - f. Miscellaneous loan debit and credit suspense accounts.
  - g. Criticized shared national credits (applicable foreign credits).
  - h. Interagency Country Exposure Review Committee determinations.
  - i. Letters of credit considered problems by management.
  - j. Information on directors, executive officers, principal shareholders and their interests.
  - k. Specific guidelines in the lending policies.
    - l. Each officer's current lending authority.
    - m. Current letter of credit commission and fee structure.
    - n. Any useful information obtained from the review of the minutes of the Loan and Discount Committee or any similar committee.
    - o. Reports furnished to the Loan and Discount Committee or any similar committee.
    - p. Reports furnished to the board of directors.
    - q. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
  - a. Participations purchased and sold (including syndicate participations).
    - Test participation certificates and records and determine that the parties share in the risks and contractual payments according to the agreement.

- Determine that the books and records of the bank properly show the bank's liability.
  - Investigate any participations sold immediately prior to the date of examination to determine if any were sold to avoid possible criticism during the examination.
- b. Loan commitments and other contingent liabilities:
- Analyze the commitment or contingent liability if the borrower has been advised of the commitment and the combined amounts of the current loan balance (if any) and the commitment or other contingent liability exceeds the cutoff.
- c. Letters of credit issued (or confirmed) for officers, directors and their interests:
- Investigate any circumstances which indicate preferential treatment.
- d. Letters of credit issued (or confirmed) for officers and directors of other banks:
- Investigate any circumstances which indicate preferential treatment.
- e. Miscellaneous loan debit and credit suspense accounts relating to letters or credit:
- Determine liability to the bank on drafts paid under letters of credit for work which the bank has not been reimbursed by the customer.
  - Investigate any large or old items.
- f. Shared national credits:
- Compare the schedule of letters of credit included in the program to the bank's reports of unexpired letters of credit.
  - For each letter of credit so identified, transcribe appropriate information to line cards. No further examination procedures are necessary in this area.
- g. Interagency Country Exposure Review Committee credits:
- Identify any credits that were selected for review that are criticized for transfer risk reasons by the Interagency Country Exposure Review Committee.
- h. Letters of credit criticized during the previous examination:
- Determine disposition of letters of credit so criticized by transcribing:
    - Current balance and payment status, or
    - Date the letter of credit was drawn down (refinanced), paid, expired or cancelled, and the source of repayment.
9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past due status relating to letters of credit.
10. Prepare credit line cards for any letter of credit not in the sample which, based on information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and loan areas and decide who will review the borrowing relationship. Pass or retain examination credit line cards.
12. Obtain credit files for all bank customers for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the letters of credit, perform the following procedures:
- a. Analyze balance sheet and profit and loss items as shown in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
  - b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
  - c. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
  - d. Review supporting information for the major balance sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate their adequacy.
  - e. Review compliance with provisions of letter of credit agreements.
  - f. Review digest of officers' memoranda, mercantile reports, credit checkings and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
  - g. Relate any collateral values, including margin and cash collateral deposits, to outstanding letter of credit debt.
  - h. Compare fees charged to the fee schedule(s), and determine that terms are within established guidelines.

- i. Compare the amount of letters of credit outstanding with the lending officer's authority.
- j. Analyze any secondary support afforded by guarantors.
- k. Ascertain compliance with the bank's established commercial loan policy.
- l. Analyze the following specific types of letters of credit (when applicable) to determine the following:
  - For red-clause letters of credit (packing credits)—
    - is clean advance or anticipatory drawing finance to the beneficiary (exporter or agent) authorized under the letter of credit?
    - does the beneficiary undertake to deliver, within the expiration date, the shipping documents called for in the letter of credit?
    - does the foreign bank make advances to the beneficiary, and is it paid by drawing its own draft on the opening bank, or is the beneficiary authorized to draw its draft on the issuing bank, and are the drafts received charged to the importer?
  - For traveler's letters of credit—
    - is a traveler's letter of credit authorizing the issuing bank's correspondent to negotiate drafts drawn by the beneficiary named in the credit, up to a specified amount, upon proper identification?
    - is the customer furnished with a list of the issuing bank's correspondents abroad?
    - is the letter of credit prepaid in full?
  - For back-to-back letters of credit—
    - is the backing letter of credit properly assigned as collateral to the bank issuing the letter of credit?
    - are the terms of the letter of credit issued identical to the backing credit, except that—
      - the beneficiary and account party are different,
      - the amount may be less but not more than the backing credit,
      - the expiration date is reduced by sufficient time to allow completion of the transaction before the backing letter of credit expires, and
- the beneficiary of the backing letter of credit is a regular customer of the bank opening the second letter of credit?
- For standby letters of credit—
  - do they represent undertakings to pay up to a specific amount on presentation of a draft (or drafts) or documents before a specified date?
  - do they represent obligations to a beneficiary on the part of the issuer to—
    - repay money borrowed by or advanced to, or for the account of, a party; or
    - make payment on account of any indebtedness undertaken by the account party, or make payment on account of default by the account party in the performance of an obligation, for example, default on loans, performance of contracts, or relating to maritime liens?
- For deferred-payment letters of credit (trade-related)—
  - does the letter of credit call for drawing of sight drafts with the provision that such drafts are not to be presented until a specified period after presentation and surrender of shipping documents to the bank?
  - is the bank's liability for outstanding letters of credit calling for deferred payment reflected as a contingent liability until presentation of such documents?
  - has the bank received, approved, and acknowledged receipt of the documents, thereby becoming directly liable to pay the beneficiary at a determinable future date (or dates)?
  - will payment be made to the beneficiary in a specified number of months or quarterly, semiannually, annually, or beyond? (If the bank has advanced money to the beneficiary against the deferred-payment letter of credit, with its proceeds assigned as collateral to repay the advance, the transaction should be treated as a loan rather than a

- deferred-payment letter of credit).
- For clean deferred-payment letters of credit—
    - do such deferred-payment credits call for future payment against simple receipt without documents evidencing an underlying trade transaction?
    - are such letters of credit shown as direct liabilities on the bank's records when drafts are presented by the beneficiary and received by the bank?
  - For authority to purchase—
    - is the authority to purchase with recourse to the drawer, without recourse to the drawer, or without recourse to the drawer but confirmed by the negotiating bank?
  - For Agency for International Development (AID) letters of credit—
    - does the bank have an AID letter of commitment authorizing the transaction?
    - has the bank checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the AID commitment?
    - does a letter of agreement between the bank and the foreign government exist, whereby the bank has recourse if AID fails to reimburse the bank?
  - For Commodity Credit Corporation (CCC) letters of credit—
    - does the bank have a CCC letter of commitment authorizing the bank under examination to issue letters of credit to beneficiaries supplying eligible commodities to foreign importers?
    - in instances where the bank has issued standby letters of credit in favor of the CCC, have the following requirements been met:
      - Has at least 10 percent of the financed amount been confirmed, i.e., guaranteed by a U.S. bank, for commercial credit risk? Is the total value of the credit advised through a U.S. bank?
    - For the Export-Import Bank (Eximbank) of the United States—
      - does the bank have an agency agreement from Eximbank stating—
        - that Eximbank has entered into a line of credit with a foreign borrower,
        - the amount of the line,
        - that the bank has been designated to issue the letter of credit (or credits), and
        - that any payments made under an Eximbank-approved letter of credit will be reimbursed by Eximbank?
      - has the bank checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the Eximbank agreement?
  - For advised (notified) letters of credit—
    - is the bank only advising the beneficiary without responsibility on its part? (These banks should not be examined unless the bank has notified the letter-of-credit terms erroneously to the beneficiary, thus resulting in a possible liability for the bank.)
  - For other types of letters of credit—
    - do any of the following U.S. government agencies and international organizations reimburse the bank for issuing letters of credit on their behalf:
      - International Bank for Reconstruction and Development (World Bank)
      - Inter-American Development Bank
      - Overseas Private Investment Corporation
13. For loans in the sample, check the central liability file on borrowers who are indebted above the cutoff, or on borrowers who display credit weaknesses or are suspected of having additional liability in other loan areas.
  14. Transcribe significant liability and other information on officers, principals, and affiliations of appropriate obligors contained in the sample. Cross-reference line cards to borrowers, where appropriate.
  15. Determine compliance with section 208.24 of Regulation H regarding standby letters of

credit by performing the following steps:

- a. Determine which letters of credit are standby letters of credit as defined by section 208.24(a) of Regulation H.
  - b. Determine that the amount of standby letters of credit does not exceed the legal limitations on loans imposed by the state (including limitations to any one customer or on aggregate extensions of credit).
    - Combine standby letters of credit with any other nonexcepted loans to the account party by the issuing bank for the purpose of applying state loan limitations to any one customer.
    - A standby letter of credit is not subject to loan limitations imposed by state law in the following instances:
      - Before or at the time of issuance of the credit, the issuing bank is paid an amount equal to the bank's maximum liability under the standby letter of credit.
      - Before or at the time of issuance, the bank has set aside sufficient funds in a segregated, clearly earmarked deposit account to cover the bank's maximum liability under the standby letter of credit.
  - c. Determine, for standby letters of credit that constitute extensions of credit under section 23A of the Federal Reserve Act when issued on behalf of an affiliate, that—
    - the legal lending limits pertaining to loans to affiliates have not been exceeded, and
    - appropriate collateral requirements have been met.
  - d. Determine that the bank maintains adequate control and clearly earmarked subsidiary records of its standby letters of credit in conformance with section 208.24 of Regulation H.
  - e. Determine that the credit standing of the account party under any standby letter of credit is the subject of credit analysis that is equivalent to that applicable to a potential borrower in an ordinary loan situation.
16. Perform the appropriate procedural steps in the "Concentration of Credits" section.
  17. Discuss with the appropriate officer (or officers) and prepare summaries in appropriate report form of—
    - a. letters of credit not supported by current and complete financial information,
    - b. letters of credit on which collateral documentation is deficient,
    - c. inadequately collateralized letters of credit,
    - d. criticized letters of credit,
    - e. concentrations of credit,
    - f. letters of credit issued in favor of major shareholders, employees, officers, directors, and their interests,
    - g. letters of credit which, for any other reason, are questionable in quality,
    - h. violations of laws and regulations, and
    - i. other matters regarding the condition of the letters-of-credit department.
  18. Prepare and give to the examiner-in-charge a written evaluation of the letters-of-credit department with respect to—
    - a. the adequacy of written policies relating to letters of credit;
    - b. the manner in which bank officers are operating in conformance with established policies;
    - c. delinquencies relating to letters of credit, segregating those considered "A" paper;
    - d. adverse trends within the letter-of-credit department;
    - e. the accuracy and completeness of the schedules obtained;
    - f. internal-control deficiencies or exceptions;
    - g. recommended corrective action when policies, practices, or procedures are deficient;
    - h. the quality of departmental management; and
    - i. other matters of significance.
  19. Update the workpapers with any information that will facilitate future examinations.

# International—Letters of Credit Internal Control Questionnaire

Effective date March 1984

## Section 7080.4

Review the bank's internal controls, policies, practices and procedures for letters of credit issued and confirmed. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written letter of credit policies that:
  - a. Establish procedures for reviewing letter of credit applications?
  - b. Define qualified customers?
  - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are letter of credit policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

- \*3. Is the preparation and posting of subsidiary letter of credit records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
- \*4. Are the subsidiary letter of credit records (control totals) balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle letters of credit and post records?
- \*5. Are delinquencies arising from the non-payment of instruments relating to letters of credit prepared for and reviewed by management on a timely basis?
- \*6. Are inquiries regarding letter of credit balances received and investigated by persons who do not normally process documents, handle settlements or post records?
- \*7. Are bookkeeping adjustments checked and approved by an appropriate officer?

- \*8. Is a daily record maintained summarizing letter of credit transaction details, i.e., letters of credit issued, payments received, and commissions and fees collected, to support applicable general ledger account entries?
9. Are frequent letter of credit record copies and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record letter of credit transactions?

### COMMISSIONS

- \*10. Is the preparation and posting of commission records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
11. Are any independent commission computations made and compared or adequately tested to initial commission records by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?

### DOCUMENTATION

12. Are terms, dates, weights, description of merchandise, etc. shown on invoices, shipping documents, delivery receipts and bills of lading scrutinized for differences with those detailed in the letters of credit instruments?
13. Are procedures in effect to determine if:
  - a. The above documents are signed when required?
  - b. All copies of letters of credit are initialed by the officer who signed the original letter of credit?
  - c. All amendments to letters of credit are approved by an officer?

### COLLATERAL

(See International—Loans and Current Account Advances section.)

## DEFERRED PAYMENT LETTERS OF CREDIT

- \*14. Are deferred payment letters of credit:
- Recorded as direct liabilities of the bank after it acknowledges receipt of the beneficiary's documents?
  - Included in "Other Assets" and "Other Liabilities" in the call report?

## STANDBY LETTERS OF CREDIT

- \*15. Are standby letters of credit segregated or readily identifiable from other types of letters of credit and/or guarantees?

## OTHER

- Are outstanding letter of credit record copies and unissued forms safeguarded during banking hours and locked in the vault overnight?
- Are advised letters of credit recorded as memoranda accounts separate from letters of credit issued or confirmed by the bank?
- Are letters of credit which have been issued with reliance upon a domestic bank, whether on behalf of, at the request of, or under an agency agreement with the domestic bank, recorded as contingent liabilities under the name of that domestic bank?
- Are any commission rebates approved by an officer?

- Does the bank have an internal review system that:
  - Re-examines collateral items for negotiability and proper assignment?
  - Test check values assigned to collateral when the letter of credit is issued or confirmed and at frequent intervals thereafter?
  - Determines that customer payments of letters of credit issued are promptly posted?
  - Determines all delinquencies arising from the non-payment of instruments relating to letters of credit?
- Are all letters of credit recorded and assigned consecutive numbers?
- Are lending officers frequently informed of maturing letters of credit and letter of credit lines?

## CONCLUSION

- Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
- Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).



State member banks may not issue guarantees and sureties except for those that may be incidental or usual in conducting banking business, such as when a bank has a substantial interest in the performance of the transaction involved or has a segregated deposit sufficient in amount to cover its total potential liability. A state member bank also may guarantee or endorse notes or other obligations sold by the bank for its own account. The amount of the obligations covered by the guaranty or endorsement is to be recorded as a liability on the bank's records. These liabilities are included in computing the aggregate indebtedness of the bank, which may be subject to limitations imposed by state law. Furthermore, a state member bank is permitted to guarantee the deposits and liabilities of its Edge Act and agreement corporations and of its corporate instrumentalities in foreign countries.

A foreign branch of a member bank may engage in certain activities under Regulation K (12 CFR 211) in addition to its general banking powers to the extent that they are consistent with its charter. Those additional activities include guaranteeing a customer's debts or agreeing to make payment on the occurrence of readily ascertainable events, including, but not limited to, nonpayment of taxes, rentals, customs duties, the cost of transportation and loss, or the non-conformance of shipping documents. The guarantee or agreement must specify maximum

monetary liability. The liabilities outstanding are subject to loan limitations on any one customer imposed by state law.

A common example of a guarantee is a shipside bond. Frequently, in an international sale of goods, the merchandise arrives at the importer's (buyer's) port before the arrival of correct and complete bills of lading. In these instances, it is customary for the importer (buyer) to obtain immediate possession of the goods by providing the shipping company with a bank guarantee, often called a shipside bond, that holds the shipping company blameless for damage resulting from release of the goods without proper or complete documents. Usually, the bank's guarantee relies on a counter-guarantee issued to the bank by the importer.

All types of guarantees issued are to be recorded as contingent liabilities by the bank. Usually, the party for whom the guarantee was issued will reimburse the bank should it be required to pay under the guarantee; however, in certain situations, some other designated party may reimburse the bank. That other party may be designated in the guarantee agreement with the bank or in the guarantee instrument itself. The bank may also be reimbursed from segregated deposits held, from pledged collateral, or by a counter-guarantor. Letters of credit, as distinguished from guarantees, are discussed in section 7080, "International—Letters of Credit."

# International—Guarantees Issued

## Examination Objectives

Effective date May 1996

## Section 7090.2

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1. To determine if policies, practices, procedures, and internal controls for guarantees issued are adequate.
2. To determine if bank officers are operating in conformance with established guidelines.
3. To evaluate the portfolio of guarantees for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it applies to guarantees.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when objectives, policies, practices, procedures, or internal controls are deficient and when violations of laws and regulations have been cited.

# International—Guarantees Issued Examination Procedures

Effective date March 1984

## Section 7090.3

1. If selected for implementation, complete or update the Guarantees Issued section of the Internal Control Questionnaire.
2. Determine the scope of the examination based upon the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer (account party) liability records and:
  - a. Reconcile balances to department controls and the general ledger.
  - b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select guarantee account parties for examination.
6. Prepare credit line cards to include:
  - a. Total line available for guarantees.
  - b. Total outstanding guarantees.
7. Obtain the following information if it is applicable to the guarantees issued area:
  - a. Loan commitments and contingent liabilities.
  - b. Miscellaneous loan debit and credit suspense accounts.
  - c. Criticized shared national credits.
  - d. Interagency Country Exposure Review Committee determinations.
  - e. Loans considered “problem loans” by management.
  - f. Specific guidelines in the lending policy.
  - g. Each officer’s current lending authority.
  - h. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
  - i. Reports furnished to the Loan and Discount Committee or any similar committee.
  - j. Reports furnished to the board of directors.
  - k. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
  - a. Miscellaneous loan debit and credit suspense accounts:
    - Determine any liability to the bank resulting from guarantees paid by the bank for which it has not been reimbursed by an account party.
    - Discuss with management any large or old items.
    - Perform additional procedures as considered appropriate.
  - b. Shared national credits:
    - Compare the schedule of guarantees issued included in the program to the bank’s reports of unexpired guarantees.
    - For each guarantee so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these items.
  - c. Interagency Country Exposure Review Committee Credits:
    - Identify any guarantees that were selected for review that are criticized for transfer risk reason by the Interagency Country Exposure Review Committee.
9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past due status.
10. Prepare credit line cards for any guarantee not in the sample which, based on information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, loans and current account advances, due from foreign banks—time, and other loan areas and decide who will review the borrowing relationship. Pass on or retain completed credit line cards.
12. Obtain credit files for all customers (account parties) for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the guarantees, perform the following procedures:
  - a. Analyze balance sheet and profit and loss figures as shown in current and preced-

- ing financial statements, and determine the existence of any favorable or adverse trends.
- b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
  - c. Review components of the balance sheet as reflected in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
  - d. Review supporting information for the major balance sheet items and the techniques used in consolidation. Determine the primary sources of repayment and evaluate the adequacy of those sources.
  - e. Determine compliance with the provisions of guarantee agreements.
  - f. Review digest of officers' memoranda, mercantile reports, credit checkings and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
  - g. Relate collateral values, if any, to outstanding guarantee.
  - h. Compare fees charged to the bank's fee schedule and determine that the terms are within established guidelines.
  - i. Compare the original amount of the guarantee with the lending officer's authority.
  - j. Analyze support afforded by counter-guarantors.
  - k. Ascertain compliance with the bank's established guarantee issued policy.
13. For guarantees issued in the sample, check central liability file on borrower(s) indebted above the cutoff or borrower(s) displaying credit weakness or suspected of having additional liability in loan areas.
  14. Transcribe significant liability and other information on officers, principals and affiliations of appropriate account parties contained in the sample. Cross-reference line cards to borrowers, where appropriate.
  15. Determine compliance with state laws and regulations pertaining to guarantees issued by performing the following steps:
    - a. Determine that the obligations covered by such guarantees or endorsements are shown as contingent liabilities on the records and in the reports of condition of the bank and that such liabilities are included in computing the aggregate indebtedness of the bank, if such limitations are imposed by state law.
    - b. Determine which guarantees are subject to individual loan limitations to any one customer by state law. Combine guarantees with any other extensions of credit to the account party by the issuing bank subject to loan limitations imposed by state law.
  16. Perform appropriate procedural steps in the Concentration of Credits section, as applicable.
  17. Discuss with appropriate officers and prepare summaries in appropriate report form of:
    - a. Guarantees not supported by current and complete financial information.
    - b. Guarantees on which collateral documentation is deficient.
    - c. Concentrations of credit.
    - d. Criticized guarantees.
    - e. Inadequately collateralized guarantees, if applicable.
    - f. Guarantees issued in favor of major shareholders, employees, officers, directors and related interests.
    - g. Guarantees, which for any other reason, are questionable as to quality and ultimate collection.
    - h. Violations of laws and regulations.
  18. Evaluate the bank with respect to:
    - a. The adequacy of written policies relating to guarantees issued.
    - b. The manner in which bank officers are operating in conformance with established policy.
    - c. Adverse trends within the guarantees issued department.
    - d. The accuracy and completeness of the schedules obtained.
    - e. Internal control deficiencies or exceptions.
    - f. Recommended corrective action when policies, practices or procedures are deficient.
    - g. The quality of departmental management.
    - h. Other matters of significance.
  19. Update the workpapers with any information that will facilitate future examinations.

# International—Guarantees Issued

## Internal Control Questionnaire

Effective date March 1984

Section 7090.4

Review the bank's internal controls, policies, practices and procedures for issuing and servicing guarantees. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies pertaining to guarantees issued that:
  - a. Establish procedures for reviewing guarantee applications?
  - b. Define qualified guarantee account parties?
  - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are guarantee policies reviewed at least annually to determine if they are compatible with changing market conditions?

### RECORDS

- \*3. Is the preparation and posting of subsidiary guarantee records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
- \*4. Are the subsidiary guarantees issued records balanced daily with the general ledger and are reconciling items adequately investigated by persons who do not normally handle guarantees?
- \*5. Are guarantee delinquencies prepared for and reviewed by management on a timely basis?
6. Are inquiries regarding guarantee balances received and investigated by persons who do not normally handle guarantees or post records?
- \*7. Are bookkeeping adjustments checked and approved by an appropriate officer?

- \*8. Is a daily record maintained summarizing guarantee transaction details, i.e., guarantees issued, guarantees cancelled or renewed, payment made under guarantees and fees collected, which support general ledger entries?
9. Are frequent guarantee instrument and liability ledger trial balances prepared and are they reconciled monthly with control accounts by persons who do not process or record guarantee transactions?

### GUARANTEE FEES

- \*10. Is the preparation and posting of fees collected records performed or reviewed by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?
11. Are independent fee computations made, compared or adequately tested to initial fee records by persons who do not also:
  - a. Issue official checks or drafts?
  - b. Handle cash?

### COLLATERAL

(See International—Loans and Current Account Advances section.)

### OTHER

12. Are guarantees issued instruments safeguarded during banking hours and locked in the vault overnight?
13. Are all guarantees issued recorded as liabilities and assigned consecutive numbers?
14. Are all guarantees issued recorded on individual customer (account party) liability ledgers?

### CONCLUSION

15. Is the foregoing information an adequate basis for evaluating internal control in that

there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

16. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

This section provides examiners with the basic principles and risks associated with foreign exchange trading. By its very nature, foreign exchange trading involves risk. The examiner's primary function is to understand that risk and ensure that bank management, by means of policies, limits, and systems, is controlling that risk in a prudent manner. For the purpose of this section, foreign currency money market functions will be combined with foreign exchange activities since the principles and risks are virtually the same.

In order to evaluate a bank's foreign exchange and controls, the examiner needs a basic understanding of the foreign exchange market, the commercial bank's role in the market, trading fundamentals, and the principal risks involved in trading.

The foreign exchange market exists to service the foreign currency needs of importers, exporters, manufacturers, and retailers. Foreign exchange transactions arising from international trade and investment are frequently large and recurrent.

Large or small, all foreign exchange transactions represent the exchange of one country's money for another's. The exchange rate is simply the price of one currency in terms of another.

Until the late 1970s, foreign exchange rates in this country were normally expressed and quoted in dollars per unit of foreign currency, also known as "U.S. Terms." Under this method, for example, the rate for Swiss francs would be expressed as CHF1=U.S.\$1.5500. However, because of vastly improved communications and a rapidly expanding market, it became necessary for traders worldwide to quote rates in a uniform manner. As a result, American foreign exchange traders began using foreign currency units per dollar or "European Terms" for most rates. Using European terms, the quote in this example would be U.S.\$1=CHF.64516. Thus, European terms represent the value of the U.S. dollar in units of the foreign currency. A quote in European terms is simply the reciprocal of a quote in U.S. terms. One major exception to this shift is the British pound sterling which, for historical purposes, is always quoted in U.S. terms such as 1£=\$1.7450.)

Any commercial bank which maintains due from bank balances, commonly known as "nostro" accounts, in banks in foreign countries

in the local currency has the capability of engaging in foreign exchange. The majority of U.S. banks restrict foreign exchange to the servicing of their customers' foreign currency needs. The banks will simply sell the currency at a rate slightly above the market and subsequently offset the amount and maturity of the transaction through a purchase from another correspondent bank at market rates. This level of activity involves virtually no exposure as currency positions are covered within minutes. A small profit is usually generated from the rate differential, but the activity is clearly designated as a service center.

Greater emphasis is placed on foreign exchange activity by regional banks. The servicing of the corporate customers' needs is also a priority, but most regional banks also participate in the interbank market. These banks look at the trading function as a profit center as well as a service. Such banks usually employ several experienced traders and, unlike the previous group, will take positions in given currencies based on anticipated rate movements.

Multinational banks assume, by far, the most significant role in the foreign exchange marketplace. While still servicing customer needs, these banks are heavily engaged in the interbank market and look to their foreign exchange trading operation for sizable profits. Such banks trade foreign exchange on a global basis through international branch networks.

A major aspect of any foreign exchange review is the ability of the examiner to determine if the bank has the capability to adequately handle the level of its foreign exchange volume and the extent of the exposures taken. This judgment is, by necessity, subjective; however, it must take into consideration asset size, capital base, customer volume in foreign exchange, depth and experience of traders, and management understanding of and commitment to trading. The fundamental principles of foreign exchange trading outlined below are designed to assist the examiner in this analysis.

### SPOT TRADING

Buying and selling foreign exchange at market rates for immediate delivery represents spot trading. In reality, spot trades have a "value

date” (maturity or delivery date) of two to five business days (one for Canada and Mexico). Foreign exchange rates that represent the present market value for the currency are known as spot rates. The risk of spot trading results from rate movements occurring when the bank’s position in foreign currency is not balanced with regard to exchange bought and sold. Such unbalanced positions are referred to as net open positions and are defined as follows:

*Net Open Positions*—A bank has a net position in a foreign currency when its assets, including spot and future contracts to purchase,

and its liabilities, including spot and future contracts to sell, in that currency are not equal. An excess of assets over liabilities is called a net “long” position and liabilities in excess of assets a net “short” position. A “long” position in a foreign currency which is depreciating will result in an exchange loss relative to book value because, with each day, that position (asset) is convertible into fewer units of local currency. Similarly, a “short” position in a foreign currency which is appreciating represents an exchange loss relative to book value because, with each day, liquidation of that position (liability) will cost more units of

## CONSOLIDATED FOREIGN EXCHANGE POSITION, MAY 4, 20XX

Amounts in thousands

<i>Monetary Unit, Overnight Limit and Description</i>	<i>Assets/Purchases</i>		<i>Liabilities/Sales</i>	
	<i>Foreign Amount</i>	<i>U.S. \$ Equivalent of Local Currency Book Value</i>	<i>Foreign Amount</i>	<i>U.S. \$ Equivalent of Local Currency Book Value</i>
<b>JAPANESE YEN (\$3,000M)</b>				
Ledger Accounts	563,437	239,461	645,013	274,310
Spot Contracts	23,502	9,802	15,973	6,709
Forward Contracts	790,250	331,905	712,533	296,342
	<u>1,377,189</u>	<u>581,168</u>	<u>1,373,519</u>	<u>577,361</u>
Net Position (long)	3,670	3,807		
<b>CANADIAN DOLLARS (\$6,000M)</b>				
Ledger Accounts	1,016,076	1,017,525	1,029,835	1,030,057
Spot Contracts	330,021	328,972	216,225	217,246
Forward Contracts	1,202,013	1,203,226	1,301,279	1,302,522
	<u>2,548,110</u>	<u>2,549,723</u>	<u>2,547,339</u>	<u>2,549,825</u>
Net Position (long)	771			102
<b>SWISS FRANC (\$250M)</b>				
Ledger Accounts <sup>1</sup>	31,768	11,932	36,052	13,571
Spot Contracts	1,526	593	2,566	969
Forward Contracts	11,174	4,274	6,545	2,521
	<u>44,468</u>	<u>16,799</u>	<u>45,163</u>	<u>17,061</u>
Net Position (short) <sup>2</sup>			695	262

1. Does not include a Swiss franc 1,000M (U.S. \$386M) unhedged investment in a Swiss subsidiary and Swiss franc 573M (U.S. \$217M) unhedged investment in branch fixed assets. The unhedged term “long” position was approved by senior bank management.

2. Net overnight position in excess of established limit. Formally approved as a special situation by senior management prior to the transaction.



local currency. (Examples of net open position schedules appropriate for use in preparing the report of examination appear on the preceding page.)

It is important to remember that the net open position consists of both balance sheet accounts and contingent liabilities. For most banks, the nostro accounts represent the principal assets; however, foreign currency loans as well as any other assets or liability accounts denominated in foreign currency that are sizable in certain banks, must be included. All future foreign exchange contracts outstanding are contingents. When a contract matures, the entries are posted to a nostro account in the appropriate currency.

Each time a bank enters into a spot foreign exchange contract, its net open position is changed. For example, assume that Bank A opens its business day with a balanced net open position in pound sterling (assets plus purchased contracts equal liabilities plus sold contracts). This is often referred to as a “flat” position. Bank A then receives a telephone call from Bank B requesting a “market” in sterling. Because it is a participant in the interbank foreign exchange trading market, Bank A is a “market maker.” This means it will provide Bank B with a two-sided quote consisting of its bid and offer for sterling. If a different currency was requested, European terms would be the opposite as the bid and offer would be for dollars instead of the foreign currency. In determining the market given, Bank A’s trader of sterling will determine where the market presently is (from brokers and/or other banks) and attempt to anticipate where it is headed and whether Bank B is planning to buy or sell sterling.

When Bank A gives its quote on sterling, \$1.7115–25 for example, it is saying that it will buy sterling (its bid) at \$1.7115 or sell sterling at \$1.7125 (its offer). If Bank B’s interest is to buy sterling and the given quote is appealing, it will buy sterling from Bank A at \$1.7125 (Bank A’s offer of sterling). Note, that while Bank B may choose to buy, sell, or pass as it wishes, it must do business on the terms established by Bank A. These terms will be in Bank A’s favor. As soon as Bank B announces it will purchase sterling at \$1.7125, Bank A acquires a net open position (short) in sterling. Bank A must then decide whether to hold its short position (in anticipation of a decline in sterling) or cover its position. Should it wish to cover, it may call another bank and purchase the

amount it sold to Bank B. However, in this case, as the calling bank, Bank A would buy its sterling from the offered side of the quote it receives and must buy it at \$1.7125 or less to avoid a loss.

Banks engaging in interbank spot trading will often be involved with sizable net open positions, though many for just brief periods. No matter how skilled the trader, each will encounter at least occasional losses. Knowing when to close a position and take a small loss before it becomes large is a necessary trait for a competent trader. Many banks employ a “stop loss policy” whereby a net open position must be covered if losses from it reach a certain level. While a trader’s forecast may ultimately prove correct within a day or week, rapid rate movements often force a loss within an hour or even minutes. Also, access to up-to-the-minute information is vital for involvement in spot trading. Banks who lack the vast informational resources of the largest multinationals may be particularly vulnerable to sudden spot rate movements prompted by inside information or even rumors. As a result, examiners should closely review banks where foreign exchange activities consist primarily of interbank spot trading.

## FORWARD TRADING

A forward transaction differs from a spot transaction in that the value date is more than two to five business days in the future. The maturity of a forward foreign exchange contract can be a few days, months, or even years in some instances. The exchange rate is fixed at the time the transaction is agreed. But nostro accounts are not debited or credited, i.e., no money actually changes hands, until the maturity date of the contract. There will be a specific exchange rate for each forward maturity, and each of those rates will generally differ from today’s spot exchange rate. If the forward exchange rate for a currency is higher than the current spot rate, dealers say the currency is trading at a “premium” for that forward maturity. If the forward rate is below the spot rate, then the currency is said to be trading at a “discount.” For instance, sterling for value in three months is at a discount if the spot rate is \$1.75 and the three-month forward rate is \$1.72.

Banks active in the foreign exchange market find that interbank currency trading for any specific value date in the future is inefficient and

engage in it only infrequently. Instead, for future maturities, banks trade among themselves as well as with some corporate customers on the basis of a transaction known as a “swap.” A swap transaction is a simultaneous purchase and sale of a certain amount of foreign currency for two different value dates. The key aspect is that the bank arranges the swap as a single transaction with a single counterparty, either another bank or a nonbank customer. This means that, unlike outright spot or forward transactions, a trader does not incur a net open position since the bank contracts both to pay and to receive the same amount of currency at specified rates.

A swap allows each party to use a currency for a period in exchange for another currency that is not needed during that time. Thus, the swap offers a useful investment facility for temporary idle currency balances of a corporation or a financial institution. Swaps also provide a mechanism for a bank to accommodate the outright forward transactions executed with customers or to bridge gaps in the maturity structure of its outstanding spot and forward contracts.

The two value dates in a swap transaction can be any two dates. But, in practice, markets exist only for a limited number of standard maturities. One of these standard types is called a “spot against forward” swap. In a spot against forward swap transaction, a trader buys or sells a currency for the spot value date and simultaneously sells or buys it back for a value date a week, a month, or three months later.

Another type of transaction of particular interest to professional market-making banks is called a “tomorrow-next” swap or a “rollover.” These are transactions in which the dealer buys or sells a currency for value the next business day and simultaneously sells or buys it back for value the day after. A more sophisticated type of swap is called a “forward-forward” in which the dealer buys or sells currency for one future date and sells or buys it back for another future date. Primarily, multinational banks specialize in transactions of that type.

Any swap transaction can be thought of as if it were a simultaneous borrowing and lending operation. For example, on September 11, Bank A “swaps in” three-month sterling in a spot against a forward transaction with Bank B. On September 13, Bank A pays dollars to Bank B’s account at a New York bank and Bank A receives sterling for its account at a bank in London. On December 13, the swap is reversed. Bank A pays

back the sterling to Bank B, while B pays back the dollars to A. In the meantime, Bank A has the use of the sterling, in effect “borrowing” sterling, while giving up use of the dollars, in effect “lending” the dollars. Banks recognize this close equivalence to actual short-term borrowing and lending. Many fold in swap transactions with other money market transactions in managing their global banking activities.

Forward exchange rates can be expressed in three ways. Like spot rates, outright forward prices are expressed in dollars and cents per currency unit or vice versa. Traders normally only quote forward prices to corporate customers or to small correspondent banks seeking to buy or sell a currency for a particular future date. For instance, a trader may quote an outright six-month rate to buy sterling of \$1.8450, while, by comparison, a quotation to buy spot sterling might be less (\$1.8200) or more (\$1.8625).

In swap transactions, the trader is only interested in the difference between spot and forward rates, the premium or discount, rather than the outright spot and forward rates themselves. Premiums and discounts expressed in points (\$0.0001 per pound sterling or € 0.0001 per dollar) are called swap rates. For the first spot rate above, the premium is 250 points (\$0.0250). For the second, the discount is 175 points (\$0.0175).

Since, in a swap, a trader is effectively borrowing one currency and lending the other for the period between the two value dates, the premium or discount is often evaluated in terms of percent per annum. For the examples above, the premium of 250 points is equivalent to 2.75 percent per annum, while the discount of 175 points is equivalent to 1.88 percent per annum. To calculate the percentage premium for the first case:

- Take the swap rate (\$0.0250)
- Multiply by 12 months and divide by 6 months (a per annum basis)
- Divide by the spot rate (\$1.8200), and
- Multiply by 100 (to get a percent basis).

On a formula basis, this can be expressed as:

$$\% \text{ per annum} = \left( \frac{\text{Premium or Discount} \times 12}{\text{Spot rate} \times \text{number of months of forward contract}} \right) \times 100$$

As can be seen from the above, forward rates (premiums or discounts) are solely influenced by the interest rate differentials between the two countries involved. As a result, when the differential changes, forward contracts previously booked could now be covered at either a profit or loss. For example, assume an interest rate differential between sterling and dollars of 3 percent (with the sterling rate lower). Using this formula, with a spot rate of \$1.80, the swap rate on a three month contract would be a premium of 135 points. Should that interest rate differential increase to 4 percent (by a drop in the sterling rate or an increase in the dollar rate), the premium would increase to 180 points. Therefore, a trader who bought sterling three months forward sterling at 135 points premium could now sell it at 180 points premium, or at a profit of 45 points (expressed as .0045).

Thus, the dealer responsible for forward trading must be able to analyze and project dollar interest rates as well as interest rates for the currency traded. Additionally, because forward premiums or discounts are based on interest rates differentials, they do not reflect anticipated movements in spot rates.

Active trading banks will, of course, have a large number of forward contracts outstanding. The portfolio of forward contracts is often called a "forward book." As a result, these forward positions must be managed on a gap basis. Normally, banks will segment their forward books into 15-day periods and show the net (purchased forward contracts less sold ones) balance for each period. A typical forward book would look as follows:

<i>Foreign Currency</i>	<i>Maturity Date</i>	<i>Purchases</i>	<i>Sales</i>	<i>Net Position for Period</i>
England (amounts in pound sterling)	Dec. 1–15	1 000 000	800 000	200 000
	16–31	700 000	900 000	(200 000)
	Jan. 1–15	1 500 000	500 000	1 000 000
	16–31	1 400 000	600 000	800 000
	Feb. 1–15	1 100 000	700 000	400 000
	16–28	1 400 000	400 000	1 000 000
	Mar. 1–31	200 000	1 300 000	(1 100 000)
	Apr. 1–30	400 000	1 600 000	(1 200 000)
	May 1–31	300 000	900 000	(600 000)
	June 1–30	350 000	450 000	(100 000)
	July 1–31	550 000	450 000	100 000
	Aug. 1–31	1 000 000	1 000 000	—
	Sept. 1–30	500 000	600 000	(100 000)
	Oct. 1–31	600 000	500 000	100 000
	Nov. 1–30	100 000	100 000	—
Dec. 1–31	100 000	200 000	(100 000)	
	Totals	11 200 000	11 000 000	200 000

In this forward book, volumes and net positions are limited with only the first three months segregated into 15-day periods with the remainder grouped monthly. The trader will use the forward book to manage his overall forward positions.

A forward book in an active currency may consist of numerous large contracts but, because of the risks in a net open position, total forward purchases will approximately equal total for-

ward sales. (Note: In the above forward book, the net position is only £200,000.) What matters in reviewing a forward book is the distribution of the positions by period. In the above example, the forward sterling is long a net 3,200,000 for the first three months (December through February) and short a net 3,000,000 for the next four months (March through June). In this instance, the forward book is structured for an anticipated decline in dollar interest rates as compared with

sterling interest rates since these sold positions could be offset (purchase of a forward contract to negate the sold forward position) at a lower price—either reduced premium or increased discount.

Trading forward foreign exchange thus involves projecting interest rate differentials and managing a forward book to be compatible with these projections. An understanding of these concepts is essential when looking at forward trading from risk and profitability aspects.

## COMPUTING FOREIGN EXCHANGE PROFITS AND LOSSES

If traders did nothing but spot transactions and never took open positions from day to day, calculating profit or loss would be straightforward. For example: on January 21, the traders buy £1,000,000 spot at \$1.75 and £3,000,000 at \$1.74 and sell £2,000,000 at \$1.7450 and £2,000,000 at \$1.7380. On the spot value dates, two business days later, the bank's *nostro* or clearing account in London is credited and debited by £4,000,000 from the maturing transactions.

The sterling position is square, since debits and credits are equal. In New York, the bank pays \$6,970,000 but receives only \$6,966,000. There is a net loss of \$4,000 on the four transactions. This is so because the bank's accountant would calculate that the traders acquired sterling at an average rate of \$1.7425 =

$$\frac{\$1,000,000 \times \$1.75 + \$3,000,000 \times \$1.74}{£4,000,000}$$

Against that, the traders sold sterling at \$1.7450, for a profit of \$5,000 (i.e., \$1.7450 – \$1.7425 = \$0.0025 × 2,000,000 = \$5,000). Traders also sold another £2,000,000 at \$1.7380 for a loss of \$9,000 (\$1.7380 – \$1.7425 = –\$0.0045 × £2,000,000 = –\$9,000). In this instance, the computed net loss of \$4,000 is precisely the same as the excess of dollar payments over dollar receipts.

In practice, computing profits and losses is far more complex for two basic reasons. Banks do not trade only for spot value—they also do forward contracts. Moreover, most major banks do not operate from day to day with completely square positions in each currency. Because of

the way different forward contracts mature each day, it is unusual for payments and receipts to balance perfectly until the traders arrange swaps to achieve that result. Because some traders take a view about the future movements of a currency, short or long positions are built up; and, because of the changing influences on market developments and traders' decisions, long or short positions can be altered any number of times each and every day.

In this kind of fluid trading environment, a bank needs to establish accounting procedures for calculating profits and losses which can handle the problem of maturity mismatches and open foreign currency positions. The principles underlying the accounting procedures are much the same from bank to bank, although specific practices vary. The first principle is that banks do not formally calculate profits or losses daily; most compute profits and losses monthly. Some banks do make these calculations more frequently for management information purposes.

The next principle is that banks calculate profits or losses on the entire foreign exchange book as of the calculation date. On any day, the book includes all spot and forward contracts which have not yet matured, along with *nostro* balances in each currency. Each contract represents a purchase or sale of a foreign currency at a specified exchange rate.

On the profit calculation date, the bank's accountants revalue the foreign exchange book. They use the latest market exchange rates, spot and forward, for each value date on which contracts are outstanding. For each contract, the difference between the current market rate for the value date of the contract and the rate specified in the contract is calculated. For example, if the bank previously bought a currency, e.g., sterling at \$1.75, and the current market rate for the relevant maturity is higher, e.g., sterling at \$1.80, there is an unrealized profit.

These calculated unrealized profits and losses are amalgamated with the realized profits or losses that accrue every day as foreign exchange contracts mature. The net profit or loss, realized plus unrealized, is then incorporated in bank operating income, reflecting the net contribution of foreign exchange trading before expenses.

To recapitulate, a bank with a large number of spot and forward contracts and possibly with open positions in one or more currencies needs a formal method of computing unrealized profits and losses at regular intervals. It uses a revaluation procedure that, in effect, measures what

the profits and losses would be if the bank covered in the market all outstanding positions that were not already covered. The revaluation procedure ensures that the bank's open positions show changes in exchange rates as they occur, rather than when open positions are eventually covered or when individual contracts mature. Periodic profit and loss calculations therefore provide bank management with ongoing insights into the performance of the trading function.

Following is an illustration of the revaluation procedure. Assume that on the revaluation date, January 15, Bank A had three outstanding contracts in its sterling book:

- A sale of £1,000,000 at \$1.75 for value March 15.
- A purchase of £3,000,000 at \$1.70 for value May 15.
- A sale of £1,000,000 at \$1.65 for value August 15.

The book is “long” £1,000,000 since purchases of sterling are greater than sales. For now, the nostro account and the calculations of realized profits and losses are left aside.

To revalue the book, the accountants find on January 15 that two-month, four-month, and seven-month forward rates in the market are \$1.80, \$1.75, and \$1.70, respectively. They proceed conceptually as if the traders were to cover the contracts at the going market rates, buying sterling to offset sales and selling sterling to offset purchases. On this basis, for the first contract, they compute an unrealized loss of \$50,000 ( $\$1.75 - \$1.80 = -\$0.05 \times \text{£}1,000,000$ ). For the second contract, they compute an unrealized profit of \$150,000 ( $\$1.75 - \$1.70 = \$0.05 \times \text{£}3,000,000$ ). For the third contract, they compute an unrealized loss of \$50,000 ( $\$1.65 - \$1.70 = -\$0.05 \times \text{£}1,000,000$ ). The net is an unrealized profit of \$50,000 which is entered on the income statement as the trading profit.

The accountant's task actually is far more complicated. A foreign exchange book of a major bank may include hundreds of outstanding contracts in a dozen or more currencies.

Value dates range from the next day to a year or more in the future. Market exchange rates are readily available for the “even” dates—one, two, three, six, twelve, and twenty-four months into the future. The Federal Reserve Bank of New York publishes such a daily series which can be used by bank accountants and examiners. But for “odd” dates, the accountant must approximate rates, possibly through a computer program that interpolates between even date quotations.

As contracts in the foreign exchange book mature, they affect the cash flow of the bank. Maturing purchase and sale contracts are treated asymmetrically. In a U.S. bank, which posts its profits and losses in dollars, maturing purchase contracts result in credits to its nostro account in that currency. Each day, the bank's accountants compute a new average acquisition rate for the nostro account based on existing holdings and all flows into the account that day. Maturing sale contracts result in debits to the nostro account. They yield a gain or loss measured against the average acquisition rate for funds available in the nostro account. The net realized profit or loss is placed in a suspense account which, at regular intervals, is incorporated into the bank's income statement along with the unrealized profits or losses resulting from the periodic revaluation of the foreign exchange book. In practice, the revaluation can be done on a worksheet as long as net positions for time periods and present market rates are known. While banks will revalue monthly and make the appropriate entries to income accounts, traders will spot-check their profitability more frequently. Examiners should understand the revaluation procedure for the necessary test checking of reported profits, as time restrictions do not normally allow for the proving of all of the bank's open positions.

To revalue the nostro accounts, which represent realized profit or loss, the net foreign currency balance is multiplied by the current spot rate and the result, or market value, is compared to the U.S. \$ equivalent on the books to determine profit or loss as shown below:

<i>Foreign Amount</i>	<i>Spot Rate</i>	<i>Market Value</i>	<i>U.S. \$ Equivalent Book Value of Ledger Accounts</i>	<i>Profit or Loss</i>
15,172	\$1.7155	26,028	21,229	+4,799

The same principle holds true when comparing market value to book, even if credit balances exist. (A market value of -19,055 and a book value of -20,155 would result in a profit of 1,100.)

A worksheet revaluation of forward contracts, for unrealized profits, is an expansion of the forward book previously shown. All rates must be expressed in “U.S. terms.”

## FORWARD BOOK

<i>Foreign Currency</i>	<i>Maturity Date</i>	<i>Purchases</i>	<i>Sales</i>	<i>Net Position for Period</i>	<i>D-Discount P-Premium Rate</i>	<i>Profit</i>	<i>Loss</i>
England	Dec. 1-15	1 000 000	800 000	200 000	.0025 P	500	
	16-31	700 000	900 000	(200 000)	25 P		500
	Jan. 1-15	1 500 000	500 000	1 000 000	15 P	1,500	
	16-31	1 400 000	600 000	800 000	15 P	1,200	
	Feb. 1-15	1 100 000	700 000	400 000	5 P	200	
	16-28	1 400 000	400 000	1 000 000	5 P	500	
	Mar. 1-31	200 000	1 300 000	(1 100 000)	5 D	550	
	Apr. 1-30	400 000	1 600 000	(1 200 000)	15 D	1,800	
	May 1-31	300 000	900 000	(600 000)	30 D	1,800	
	June 1-30	350 000	450 000	(100 000)	45 D	450	
	July 1-31	550 000	450 000	100 000	5 P	50	
	Aug. 1-31	1 000 000	1 000 000	—	25 D	—	
	Sept. 1-30	500 000	600 000	(100 000)	0	—	
	Oct. 1-31	600 000	500 000	100 000	45 D	—	450
	Nov. 1-30	100 000	100 000	—	25 D	—	
	Dec. 1-31	100 000	200 000	(100 000)	5 P	—	50
	Totals	11 200 000	11 000 000	200 000		+7550	

In completing a worksheet in the above format, the following must be kept in mind:

- A long position at a premium = profit
- A short position at a premium = loss
- A long position at a discount = loss
- A short position at a discount = profit

The \$7,550 is simply the profit that would be obtained if the forward book positions were fully liquidated at this time, i.e., purchases offset by sales. To calculate the profit, the unrealized profit from the previous month (\$6,400 in this example) must be reversed. Thus, the sterling profit for this month would be:

\$4,799	Nostro balance profit
7,550	Forward book profit (unrealized)
-6,400	Reversal of last month's forward book
\$5,949	Sterling profit for the month

Most automated systems will eliminate the need for manual calculations. However, the

resulting figure is only as accurate as the rates applied. As a result, examiners should test-check at least one major currency using independent rates (supplied by the Federal Reserve Bank of New York or another independent source). This should be done concurrently with the bank's own monthly revaluation. If a sizeable discrepancy results, rates and revaluation methods used by the bank should be reviewed with both management and the traders.

## DEFINING AND CONTROLLING FOREIGN EXCHANGE RISKS

Foreign exchange trading encompasses a variety of risks. Exchange rate risk, maturity gaps and interest rate risk relate to spot and forward trading. The latter two risks relate to exposures inherent in all phases of international banking.

## Exchange Rate Risk

Exchange rate risk is an inevitable consequence of trading in a world in which foreign currency values move up and down in response to shifting market supply and demand. When a bank's dealer buys or sells a foreign currency from another bank or nonbank customer, exposure from a net open position is created. Until the time that the position can be covered by selling or buying an equivalent amount of the same currency, the bank is exposed to the risk that the exchange rate might move against it. That risk exists even if the dealer immediately seeks to cover the position because, in a market in which exchange rates are constantly changing, a gap of just a few moments can be long enough to transform a potentially profitable transaction into a loss. Since exchange rate movements can readily accumulate in one direction, a position carried overnight or over a number of days entails greater risk than one carried a few minutes or hours. Again, the acid test of a good trader is to know when to take a small loss before it becomes larger.

At any time, the trading function of a bank may have long positions in some currencies and short positions in others. These positions do not offset each other, even though, in practice, some currencies do tend to move more or less together. The bank's traders recognize the possibility that the currencies in which they have long positions may fall in value and currencies in which they have short positions may rise. Consequently, gross trading exposure is measured by adding the absolute value of each currency position expressed in dollars. The individual currency positions and the gross dealing exposure must be controlled to avoid unacceptable risks.

To accomplish this, management limits the open positions dealers may take in each currency. Practices vary among banks, but, at a minimum, limits are established on the magnitude of open positions which can be carried from one day to the next (overnight limits). Several banks set separate limits on open positions dealers may take during the day. These are called "daylight" limits. Formal limits on gross dealing exposure also are established by some banks, while others review gross exposure more informally. The various limits may be administered flexibly, but the authority to approve a temporary departure from the norm is typically reserved for a senior officer.

For management and control purposes, most banks distinguish between positions arising from actual foreign exchange transactions (trading exposure) and the overall foreign currency exposure of the bank. The former includes the positions recorded by the bank's trading operations at the head office and at branches abroad. In addition to trading exposure, overall exposure incorporates all bank assets and liabilities denominated in foreign currencies including loans, investments, deposits, and the capital of foreign branches. Control of overall foreign currency exposure usually is the responsibility of a senior officer accountable to the bank's senior management.

## Maturity Gaps and Interest Rate Risk

Interest rate risk arises whenever there are mismatches or gaps in the maturity structure of a bank's foreign exchange forward book. Managing maturity mismatches is an exacting task for a foreign exchange trader.

In practice, the problem of handling mismatches is involved. Eliminating maturity gaps on a contract-by-contract basis is impossible for an active trading bank. Its foreign exchange book may include hundreds of outstanding contracts. Some will mature each business day. Since the book is changing continually as new transactions are made, the maturity gap structure also changes constantly.

While remaining alert to unusually large mismatches in maturities that call for special action, traders generally balance the net daily payments and receipts for each currency through the use of rollovers. Rollovers simplify the handling of the flow of maturing contracts and reduce the number of transactions needed to balance the book. Reliance on day-to-day swaps is a relatively sound procedure as long as interest rate changes are gradual and the size and length of maturity gaps are controlled. However, it does leave the bank exposed to sudden changes in relative interest rates between the United States and other countries, which influence market quotations for swap transactions and, consequently, the cost of bridging the maturity gaps in the foreign exchange book.

The problem of containing interest rate risk is familiar to major money market banks. Their business often involves borrowing short-term and lending longer-term to benefit from the

normal tendency of interest rates to be higher for longer maturities. But in foreign exchange trading, it is not just the maturity pattern of interest rates for one currency that counts. Rather, in handling maturity gaps, the differential between interest rates for two currencies is decisive. So the problem is more complex.

To control interest rate risk, senior management generally imposes limits on the magnitude of mismatches in the foreign exchange book. Procedures vary, but separate limits are often set on a day-to-day basis for contracts maturing during the following week or two and for each consecutive half-monthly period for contracts maturing later. At the same time, management relies on branch officers abroad, domestic money market experts, and its Economic Research Department to provide an ongoing analysis of interest rate trends.

## Credit Risk

When a bank books a foreign exchange contract, it faces a risk, however small, that the counterparty will not perform according to the terms of the contract. In both instances, there is a credit risk, although, in the foreign exchange case no extension of credit is intended. To limit credit risk, a careful evaluation of the creditworthiness of the customer is essential. Just as no bank can lend unlimited amounts to a single customer, no bank would want to trade unlimited amounts of foreign exchange with one counterparty.

Credit risk arises whenever a bank's counterparty is unable or unwilling to fulfill its contractual obligations. That happens most blatantly when a corporate customer enters bankruptcy or a bank counterparty is declared insolvent. In any foreign exchange transaction, each counterparty agrees to deliver a certain amount of currency to the other on a particular date. Every contract is immediately entered into the bank's foreign exchange book. In balancing its trading position, a bank counts on that contract being carried out in accordance with the agreed upon terms. If the contract is not liquidated, then the bank's position is unbalanced and the bank is exposed to the risk of changes in the exchange rates. To put itself in the same position it would have been in if the contract had been performed, a bank must arrange for a new transaction. The new transaction may have to be arranged at an adverse exchange rate. The trustee for a bankrupt com-

pany may perform only contracts which are advantageous to the company and disclaim those contracts which are disadvantageous.

Another and potentially more pernicious form of credit risk stems from the time zone differences between the United States and foreign nations. Inevitably, a bank selling sterling, for instance, must pay pounds to a counterparty earlier in the day than it will be credited with dollars in New York. In the intervening hours, a company can go into bankruptcy or a bank can be declared insolvent. Thus, the dollars may never be credited.

Managing credit risk is the joint responsibility of the bank's trading department and its credit officers. A bank normally deals with corporations and banks with which it has an established relationship. Dealing limits are set for each counterparty and are adjusted in response to changes in its financial condition. In addition, some banks set separate limits on the value of contracts that may mature on a single day with a particular customer. Some banks, recognizing credit risk increases as maturities lengthen, restrict dealings with certain customers to spot transactions or require compensating balances on forward transactions. A bank's procedures for evaluating credit risk and minimizing exposure are reviewed by supervisory authorities as part of the regular examination process.

## Transfer Risk

At one time or another, virtually every country has interfered with international transactions in its currency. Interference might take the form of regulation of the local exchange market, restrictions on foreign investment by residents, or limits on inflows of investment funds from abroad. Governments take such measures for a variety of reasons: to improve control over the domestic banking system, or to influence the pattern of receipts and payments between residents and foreigners. Restrictions on the exchange market or on international transactions generally are intended to affect the level or movement of the exchange rate.

Changes in regulations or restrictions usually do have an important exchange market impact. From the viewpoint of a commercial bank's foreign currency traders, most disruptive are changes in rules which interfere with the normal payments mechanism. Traders make foreign



exchange contracts on the expectation that both parties will perform according to the terms of the contract. But if government regulations change and a counterparty is either forbidden to perform as expected or is required to do something extra, then a trader might be left with an unintended open position or an unintended maturity mismatch. As described in the previous section, dealing with unintended long or short positions can be costly.

Other changes in official regulations do not in the first instance, affect the payments mechanism, but they do influence international investment transactions. Consequently, when one of the factors affecting the buying or selling of a currency changes, the exchange rate is likely to respond. Currency traders usually try to limit open positions and maturity gap mismatches, whenever modifications in official regulations appear likely. Nevertheless, changes in controls often are unpredictable; and unanticipated changes in regulations can spark significant exchange rate response.

Monitoring and responding to changing official exchange controls abroad has to be done by a well-run foreign exchange trading function. Most U.S. banks have judged that the simplest approach is to avoid trading in those currencies for which the market is heavily regulated. This decision is reflected in turnover statistics which show that trading is concentrated in the major currencies subject to the fewest controls; generally the euro, Canadian dollar, British pound sterling, Swiss franc, and Japanese yen.

## POLICY

The relative importance of each of those risk determinants varies with each currency traded and with the country of each counterparty. Senior bank management must fully understand the risks involved in foreign exchange and money market operations and must establish, in writing, its goals and policies regarding those risks. Management must be able to defend logically the basis upon which such policies are formed. It is imperative that responsible officers, traders, clerks and auditors fully understand the intent as well as the detail set forth in those directives.

At a minimum, policies should define dealing limits and reporting requirements as well as

accounting and audit and control systems to provide for proper surveillance over those limits and exceptions thereto.

Limits must be established for overnight net positions in each currency. Depending on the size of the limits and the manner in which they are calculated, a smaller aggregate position limit for all currencies may be desirable. An aggregate limit should not permit the netting of short against long positions, but should require that they be added to determine conformance to that limit. Many U.S. banks consider whether to establish daylight (intraday) position limits only if efficient computerization and input systems are in effect to incorporate each trade into the appropriate currency position at nearly the precise moment it is transacted.

Gap (net inflow and outflow) limits must be instituted to control the risk of adverse rate movement and liquidity pressures for each currency for each daily, weekly, and biweekly future time frame designated in the bank's maturity reports. Such limits might range from stated absolute amounts for each time frame to weighted limits that emphasize increasing rate movement exposure applicable to the relative distance into the future in which the gap appears.

Aggregate trading and placement limits must be established for each customer, based primarily on the amount of business considered to be appropriate to its creditworthiness and, secondly, on the volume of its foreign currency needs. In addition, absolute sub-limits should be placed upon the amount of that customer's business that may be settled on one day. Should the customer be unable to meet obligations on one day, the trader will:

- Be forewarned against delivery prior to receipt of customer funds on the remaining contracts outstanding, and
- Have an opportunity to determine whether alternate cover must be obtained to meet third-party transactions that may initially have provided cover for the remaining transactions with that customer.

It is difficult to monitor aggregate volume limits effectively and ensure compliance with settlement limits for a large number of customers. An effective settlement limit program for at least those relationships that possess a greater potential for late delivery or default should be enacted by senior management.

## REPORTS

Properly designed reports are the most important supervisory tool available to management. They must be prepared in a concise, uniform, and accurate manner and submitted punctually. Management should receive daily net position reports for each currency traded. Normally, position reports should include all foreign currency balance sheet items and future contracts as well as afterhour and holdover transactions, excepting fixed assets and equity investments. The hedging of those investments is usually a management decision outside the normal responsibility of the traders. The reports should be prepared by the foreign exchange and money market bookkeeping section and reconciled daily to the trader's blotter. In the event that formal position reports cannot be submitted at the end of a business day, management should be apprised of the traders estimated position at the end of each day and especially before weekends and holidays.

Gap or maturity reports are essential to the proper management of a bank's liquidity in each foreign currency and significant maturity gaps may affect overall liquidity. Those reports should show daily gaps for at least the first two weeks to one month. Beyond that time, gap periods of a maximum of two weeks each are preferred. Gap reports are generally accurate only for the day on which they are prepared. Therefore, it is essential that banks have the capability to produce detailed management reports daily. Loans, deposits, and future contracts, as well as commitments to take or place deposits should be reflected in the periods in which they are scheduled for rollover or interest adjustment. In most instances, an additional report showing those items at final maturity is desirable in analyzing the bank's medium- and longer-term dependence on money market funding sources.

Exception reports must be promptly generated upon the creation of excesses to position limits, gap limits, and customer trading and settlement limits. Excesses over any established limits should conform to overall policy guidelines and should receive prior approval by the responsible supervisory officers. If prior approval is not possible, evidence of subsequent officer concurrence or disagreement as well as any corrective action should be available for audit review and management records.

## REVALUATION AND ACCOUNTING SYSTEMS

Revaluation and accounting systems should be in place to accurately determine actual as well as estimated future profits and losses and to present them in such a manner as to facilitate proper income analysis by management, bank supervisory personnel, and the public. A bank's revaluation procedure should be test-checked at the time of monthly revaluation using independently obtained rates. While methods and systems may vary to some degree within banks, all revaluation systems should incorporate the following two aspects:

- Actual realized profit or loss as determined by applying current spot rates to balance sheet accounts as well as contracts of near maturities. Adjustments to the local currency book values would either be allocated and posted to each of the applicable local currency ledger accounts or, for short interim periods, be charged to a separate foreign exchange adjustment account with an offset to the profit and loss account.
- Unrealized (estimated future) profit or loss on future transactions as determined by applying the appropriate forward rates to the net positions shown for each future period appearing in the bank's gap or maturity reports. An account such as "estimated profit (loss) on foreign exchange—futures" should be charged or credited for the amount of the adjustment with an offset to the profit and loss account. Provided that the amount of that adjustment is the difference between the existing forward rates and the actual contract rates, each month's entries merely involves reversing the adjustment from the prior revaluation and entering the new figures.

## SPECIALIZED TRANSACTIONS

### Financial Swaps

A financial swap is the combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another. It is merely trading one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange

is made and the forward contract matures. The swap is the simple identification of one transaction contracted at the spot rate with another transaction contracted at the forward rate to establish the exchange cost or profit related to the temporary movement of funds into another currency and back again. That exchange (swap) profit or cost must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. For example, the true yield of an investment for 90 days in United Kingdom Treasury bills cannot be determined without having considered the cost or profit resulting from the swap needed to make pounds sterling available for that investment. Likewise, the trading profits or losses generated by the trader cannot be determined if financial swap profits and expenses are charged to the exchange function rather than being allocated to the department whose loans or investments the swap actually funded.

## Arbitrage

As it pertains to money markets and foreign exchange, arbitrage may take several forms. The creation of an open position in a currency in anticipation of a favorable future movement in the exchange rate, in addition to being speculative, is sometimes referred to as “arbitrage in time.” Buying a currency in one market and simultaneously selling it for a profit in another market is called “arbitrage in space.” Slightly more involved is the practice of interest arbitrage which involves the movement of funds from one currency to another so they may be invested at a higher yield. The real yield advantage in such a situation is not determined merely by the difference in interest rates between the two investment choices, but rather by subtracting the cost of transferring funds into the desired currency and back again (the swap cost) from the interest differential. For example, there is no arbitrage incentive involved in swapping from dollars into the other currency at a 60 point per month discount (swap cost) which exactly offsets the 3 percent gain in interest. However, should the swap rate move to 40 points per month (or 480 points per year), the investment might become attractive. This can be tested by converting the swap rate to an annual percentage rate:

$$\frac{\text{Discount or Premium} \times 360 \times 100}{\text{Spot rate} \times \text{No. of days of future contract}} = \% \text{ P.A.}$$

$$\frac{.0040 \times 360 \times 100}{2.4000 \times 30} = 2\% \text{ P.A.}$$

This results in a true yield incentive of 1 percent, 3 percent less the swap cost of 2 percent.

Unless the bank’s accounting system can identify swap costs or profits and allocate them to the investments for which they were entered, both the earnings on those investments and the earnings upon which the trader’s performance are measured will be misstated.

## Options

Option contracts permit a bank to contract to buy from or sell to a customer when that customer can only generally predict the dates when the currency will be required. The option contract specifies the dates, and the rate cited is that which, in the judgment of the trader at the time of making the contract, contains the least exposure for the bank. This type of contract is commonly requested by commercial customers who wish to cover drafts drawn under letters of credit denominated in a foreign currency. Such contracts involve more risk as there is no way for the bank to acquire a precisely matching cover.

## Compensated Contracts

There are occasions when both parties are agreeable to altering the terms of an existing contract. Such alterations should be approved by a bank officer without responsibilities in the trading room and the operations personnel must be advised of each compromise to avoid settlement in accordance with the original instructions and terms.

## OTHER RELATED MATTERS

### Departmental Organization and Control

It is imperative that there be a distinct separation

of duties and responsibilities between the trading and the accounting and confirmation functions within the department. Many opportunities exist to avoid established limits and policies or for personal financial gain, whether by speculating beyond loosely controlled limits, concealing contracts because of poor confirmation procedures or by simple fraud. Periodic audits and examinations are no substitute for the existence of sound safeguards.

### Supervision of Branches and Subsidiaries

Whether a bank maintains central control over all foreign-exchange and money market activi-

ties at the head office or elects to decentralize that control, the policies, systems, internal controls, and reporting procedures should not differ among separate offices within the bank.

The bank should be apprised of its worldwide positions by daily summary reports. Detailed net position and maturity gap reports should be received periodically in order to prepare consolidated positions, as required, and to monitor individual unit trading volume and funding methods.

# International—Foreign Exchange Examination Objectives

Effective date March 1984

## Section 7100.2

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1. To determine if the policies, practices, procedures and internal controls regarding foreign exchange activities are adequate.
2. To determine if bank officers, traders and clerks are operating within the established guidelines.
3. To determine the extent of risk attributable to net open positions, maturity gaps and counterparty credit weakness.
4. To determine the scope and adequacy of the audit function.
5. To determine if the revaluation and accounting systems are adequate and accurately reflect the results of the trading operation.
6. To determine compliance with laws and regulations.
7. To initiate corrective action when policies, practices, procedures or internal controls are deficient, or when violations of laws or regulations have been noted.

# International—Foreign Exchange Examination Procedures

Effective date March 1984

## Section 7100.3

1. If selected for implementation, complete or update the foreign exchange section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal and external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal/external auditors, and determine if appropriate corrections have been made.
4. Obtain a trial balance, including local currency book values, of customer spot and future contract liabilities by customer and by maturities and:
  - a. Agree or reconcile balances to appropriate subsidiary controls and to the general ledger.
  - b. Review reconciling items for reasonableness.
5. Review foreign currency and appropriate local currency subsidiary control ledgers to determine that for each local currency entry there is an accompanying foreign currency entry unless they represent:
  - a. Brokerage charges to the local currency ledger.
  - b. Profit and loss adjustments to the local currency ledger.
  - c. Correction of errors in either ledger.
6. Provide liability and other information on common borrowers to the examiner assigned to "International—Loans and Current Account Advances."
7. Identify those contracts with counterparties who are affiliates of or otherwise related to the bank, its directors, officers, employees, or major shareholders, and
  - a. Compare the contracted rates with available rates for the same transaction date or with other similar contracts entered as of the same transaction date.
  - b. Investigate any instances involving off-market rates.
8. Perform an independent revaluation of at least one major currency using rates obtained from independent sources, and compare results to the accounting department's monthly foreign exchange profit and loss entries.
9. Check the most recent revaluation workpapers and resultant accounting entries to determine that:
  - a. Foreign currency amounts and book values were properly reconciled to subsidiary ledger controls.
  - b. Rates used are representative of market rates as of revaluation date.
  - c. Arithmetic is correct.
  - d. Profit and loss results are separately recorded and reported to management for:
    - Realized profit or loss, i.e., that which is determined through the application of spot rates.
    - Unrealized (estimated future) profit and loss, i.e., that which is determined through the application of forward rates.
  - e. Financial swap related assets, liabilities and future contracts are excluded from the normal revaluation process so that the results identified in step 9d reflect more accurately the trader's outright dealing performance.
  - f. Financial swap related costs and profits are:
    - Amortized over the life of the applicable swap.
    - Appropriately accounted for as interest income and expense on loans, securities, etc. Test financial swap income and expense calculations and verify the accounting entries.
10. Review workpapers for selected revaluations performed since last examination. Test-check and, if satisfied that they are accurate,
  - a. Analyze combined realized earnings to determine that profits are commensurate with risks taken.
  - b. Analyze monthly unrealized revaluation results (forecasts) to determine that:
    - The resulting amount for the last revaluation, if loss, is not large.
    - An increasing loss trend over previous revaluations does not exist. (Although month-to-month variations are not uncommon, an increasing unrealized loss trend could indicate that a trader is

- caught in a loss position and is pursuing a notion that a negative trend in the exchange rate for that currency will reverse and, if combined with an ever multiplying increase in volume, might eventually be able to repay accumulated losses.)
11. Obtain the percentage of total contracts outstanding (dollar value of purchases plus sales that are with corporate customers). Analyze this percentage in regard to trend and comparison, if possible, to banks with similar trading volume. Ascertain if corporate volume is commensurate with written policy in regards to purpose and scope of the foreign exchange trading function.
  12. Determine compliance with laws and regulations pertaining to foreign exchange activities by performing the following for Foreign Currency Forms FC-1, FC-1a, FC-2, and FC-2a:
    - a. Obtain the most recently prepared monthly and weekly reports and review for accuracy.
    - b. Select random bank-prepared daily net position reports for Wednesdays and month-end business days and test to see that:
      - Reports are being filed as required.
      - Reports are accurate.Be aware of instances in which net positions are generally large but reduced as of Wednesday and month-end reporting dates.
  13. Discuss with appropriate officers and prepare in appropriate report format:
    - a. Net position schedules.
    - b. Maturity gap schedules.
    - c. Frequent or sizeable excesses over any established limits.
    - d. Any limits deemed excessive relative to:
      - Management's policy goals regarding the nature and volume of business intended.
      - The bank's capital structure.
      - The creditworthiness of trading counterparties.
      - Individual currencies which are subject to or are experiencing relatively sporadic rate changes.
      - Individual currencies for which limited spot and future markets exist.
      - Experience of traders.
      - The bank's foreign exchange earnings record.
    - e. The absence of any limits deemed appropriate in present and foreseeable circumstances.
    - f. Customers whose obligations are otherwise previously classified or intended to be criticized.
    - g. Foreign exchange contracts which, for any other reason, are questionable in quality or ultimate settlement.
    - h. Violations of laws and regulations.
    - i. Deficiencies in internal controls.
    - j. Other matters regarding the efficiency and general condition of the foreign exchange department.
  14. Update the workpapers with any information that will facilitate future examinations.

# International—Foreign Exchange Internal Control Questionnaire

Effective date March 1984

## Section 7100.4

A review of the bank's internal controls, policies, practices and procedures regarding foreign exchange trading is essential to ensure no excessive risk or exposures exist. The bank's systems should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk are particularly significant and require substantiation by observation or testing.

### POLICIES

1. Has the board of directors, consistent with its responsibilities, adopted written policies governing:
  - a. Trading limits, including:
    - Overall trading volume?
    - Overnight net position limits per currency?
    - Intra-day net position limits per currency?
    - Aggregate net position limit for all currencies combined?
    - Maturity gap limits per currency?
    - Individual customer aggregate trading limits, including spot transactions?
    - Written approval of excesses to above limits?
  - b. Segregation of duties among traders, bookkeepers and confirmation personnel?
  - c. Accounting and revaluation procedures?
  - d. Management reporting requirements?
2. Do policies attempt to minimize:
  - a. Undue pressure on traders to meet specific budgeted earnings goals?
  - b. Undue pressure on traders, by account officers, to provide preferred rates to certain customers?
- \*3. Are traders prohibited from dealing with customers for whom trading lines have not been established?
4. Are all personnel, except perhaps the head trader, prohibited from effecting transactions via off-premises communication facilities?
5. Is approval by a non-trading officer required for all compensated transactions?
6. Do credit approval procedures exist for settlement (delivery) risk either in the form of settlement limits or other specific management controls?
7. Does a policy procedure exist to ensure that, in case of an uncertain or emergency situation, the bank's delivery will not be made before receipt of counterpart funds?
8. Do the above policies apply to all branch offices as well as majority-owned or controlled subsidiaries of the bank?
9. Does the bank have written policies covering:
  - a. Foreign exchange transactions with its own employees?
  - b. Foreign exchange transactions with members of its board of directors?
  - c. Its traders' personal foreign exchange activities?
  - d. Its employees' personal business relationships with foreign exchange and money brokers with whom the bank trades?
- \*10. Are the above policies understood and uniformly interpreted by all traders as well as accounting and auditing personnel?

### TRADING FUNCTION

11. Is a trader's position sheet maintained for each currency traded?
- \*12. Does management receive a trader's position report at the end of each trading day?
- \*13. Does the trader's position report reflect the same day's holdover and after-hours transactions?
14. Are trader's dealing tickets prenumbered?
  - a. If so, are records and controls adequate to ascertain their proper sequential and authorized use?
  - \*b. Regardless of whether or not prenumbered,
    - Are dealing tickets time date stamped, as completed, or
    - Are dealing tickets otherwise identified with the number of the resultant contract to provide a proper audit trail?



## ACCOUNTING AND REPORTING

- \*15. Is there a definite segregation of duties, responsibility and authority between the trading room and the accounting and reporting functions within the division and/or branch?
16. Are contract forms prenumbered (if so, are records and controls adequate to ensure their proper sequential and authorized use)?
17. Are contracts signed by personnel other than the traders?
- \*18. Are after-hours or holdover contracts posted as of the dates contracted?
- \*19. Do accounting personnel prepare a daily position report, for each applicable currency, from the bank's general ledger and:
- Do reports include all accounts denominated in foreign currency?
  - Are those reports reconciled daily to the trader's position reports?
  - Are identified or unreconciled differences reported immediately to management and to the head trader?
  - Are all counterparty non-deliveries on expected settlements reported immediately to management and to the head trader?
- \*20. Are maturity gap reports prepared for liquidity and foreign exchange managers at least biweekly to include:
- Loans and deposits reflected in the appropriate forward maturity periods along with foreign exchange contracts?
  - Loans, deposits and foreign exchange contracts (specify whether reflected in the maturity periods in which they fall due or in which they are scheduled for rollover \_\_\_\_\_)?
  - Commitments to accept or place deposits reflected in the appropriate maturity periods by both value and maturity dates?
  - All those items (specify whether as of the day on which they mature or bi-weekly or monthly maturity periods \_\_\_\_\_)?
  - All those items as of the day on which they mature, if necessary, i.e., in the event of a severe liquidity situation?
- \*21. Does the accounting system render excesses of all limits identified at step 1 immediately to appropriate management and is officer approval required?
- \*22. Are local currency equivalent subsidiary records for foreign exchange contracts balanced daily to the appropriate general ledger account(s)?
- \*23. Are foreign exchange record copy and customer liability ledger trial balances prepared and reconciled monthly to subsidiary control accounts by employees who do not process or record foreign exchange transactions?
24. Do the accounting and filing systems provide for easy identification of "financial swap" related assets, liabilities and future contracts by stamping contracts or maintaining a control register?

## CONFIRMATIONS

25. Is there a designated "confirmation clerk" within the accounting section of the division or branch?
- \*a. Incoming confirmations:
- Are incoming confirmations delivered directly to the confirmation clerk and not to trading personnel?
  - Are signatures on incoming confirmations verified with signature cards for:
    - Authenticity?
    - Compliance with advised signature authorizations of the counterparty?
  - Are all data on each incoming confirmation verified with file copies of contracts to include:
    - Name?
    - Currency denomination and amount?
    - Rate?
    - Transaction date?
    - Preparation date if different from transaction date?
    - Maturity date?
    - Delivery instructions, if applicable?
  - Are discrepancies directed to an officer apart from the trading function for resolution?
  - Is a confirmation discrepancy log or other record maintained to reflect the identity and disposition of each discrepancy?

- Are telex tapes retained for at least 90 days as ready reference to rates and delivery instructions?
- \*b. Outgoing confirmations:
  - Are outgoing confirmations mailed/telexed on the day during which each trade is effected?
  - Are outgoing confirmations addressed to the attention of persons other than trading personnel at counterparty locations?
  - Does the accounting and/or filing system adequately segregate and/or identify booked contracts for which no incoming confirmations have been received?
  - Are follow-up confirmations sent by the confirmation clerk if no corresponding, incoming confirmation is received within a limited number of days after the contract is effected (if so, specify \_\_\_\_\_)?
  - Is involvement by the auditing department required if no confirmation is received within a limited number of days after the transmittal of the second request referred to above (if so, specify \_\_\_\_\_)?
  - Are confirmation forms sent in duplicate to customers who do not normally confirm?
  - Are return copies required to be signed?

## REVALUATIONS

- \*26. Are revaluations of foreign currency accounts performed at least monthly?
  - a. Does the revaluation system provide for segregation of and separate accounting for:
    - Realized profits and losses, i.e., those which are determined through the application of spot rates?
    - Unrealized profits and losses, i.e., those which are determined through the application of forward rates?
  - b. Are financial swap related assets, liabilities and future contracts excluded from

- the revaluation process so that the results identified in step 26a above more accurately reflect the trader's outright dealing performance?
- c. Are financial swap costs and profits:
  - Amortized over the life of the applicable swap?
  - Appropriately accounted for as interest income and expense on loans, securities, etc?
- d. Are rates provided by, or at least verified with, sources other than the traders?

## OTHER

- \*27. Is the bank's system capable of adequately disclosing sudden increases in trading volume by any one trader?
- 28. Do such increases require officer review to insure that the trader is not doubling volume in an attempt to regain losses in his or her positions?
- 29. Does the bank retain information on, and authorizations for, all overdraft charges and brokerage bills within the last 12 months?
- 30. Does an appropriate officer review a comparison of brokerage charges, monthly, to determine if an inordinate share of the bank's business is directed to or handled by one broker?

## CONCLUSION

- 31. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
- 32. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

# International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

Effective date September 1992

## Section 7110.1

The prospects for full LDC debt repayment decreased during the mid-1980s because of depressed commodity prices and inflated interest rates. The market value of public and private sector LDC loans fell sharply below book value to the point where those loans became deeply discounted. A secondary market for trading LDC debt evolved and reached a degree of maturity in 1987 when banks significantly increased their loan loss reserves for their exposures to LDCs. Financial institutions in the United States and overseas, including commercial, merchant and investment banks, began to actively purchase, sell, swap and rent debt obligations of less developed countries for their own account and as intermediaries for others. U.S. multinational banks with significant LDC loan exposures established LDC trading units which initially had the primary responsibility to decrease the banks' LDC portfolios. As the secondary market matured, these units not only traded for their own accounts but became market makers and/or active participants in purchasing, selling, swapping and renting LDC debt. An options market based on LDC debt also is emerging.

The LDC debt market, once dismissed as illiquid, has evolved from a trickle of activity between 1985 through 1988, to a turnover of approximately \$100 billion during 1990. This momentum is expected to continue as participants in this market have realized the potential for generating substantial profits in trading LDC debt. The majority of this paper is Latin American, followed by Eastern European and African obligations. Debt of approximately 30 countries in 300 instruments may be handled by an active participant.

The LDC trading arena includes a broad range of counterparties. Although multinational banks with significant LDC debt exposures are the most active participants in the market, the number of intermediaries and principals has grown substantially. International financial institutions, corporations, high net worth individuals and public sector entities are primarily engaged in buying, selling and renting LDC debt for their own account.

The price of LDC paper, which is almost always at a discount from face amount, may vary widely, depending on the issuer and maturity of the instrument and the country of risk.

Prices (and liquidity) in the LDC debt market are influenced by a multitude of factors such as the ability/intent of public and private sector borrowers to service the debt, availability of debt-equity exchange programs, anticipated refinancing of existing debt programs and the underlying political and economic conditions in the developing countries.

Banks generally participate in this market to decrease their LDC exposures; however, some banks are also motivated to:

- Generate trading profits from the spread between the bid and offer prices
- Produce fee and commission revenues from acting as intermediaries for principals and brokers
- Participate in swap programs to facilitate debt/equity market development

Pricing, liquidity, potential conflicts of interest, violation of U.S. and foreign country laws and operational inefficiencies are the major problems faced by banks which are active market participants. The lack of liquidity in the secondary market for LDC paper could present a variety of risks to market participants. In the absence of depth in the market, the judgement of the trader is a significant factor in determining the current price of thinly traded issues. The reliance on one individual to determine prices and using those amounts to revalue the position, could result in under or overstating the profit and loss and the valuation of the position itself. A conflict of interest could result in potential future liability if there is no clear segregation of duties and responsibilities between a bank's trading in LDC assets and its role on debt renegotiation committees.

Access to LDC debt rescheduling information could give a bank unfair advantage over other creditor banks, which do not participate in the restructuring process. Another concern is the potential for a bank or its employees to knowingly or inadvertently violate U.S. or foreign country laws or aid or abet violations by its customers or trading partners. It is clear that banks have a responsibility to determine that they deal only with reputable counterparties. The relative newness of the market and the absence of industry guidelines pose challenges to both bank managements and the bank supervisory agencies.

# International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

## Examination Objectives

Effective date September 1992

## Section 7110.2

The objectives of conducting an examination of LDC asset purchases, sales, trading, swaps, rentals and options should include the following:

1. To determine if LDC asset purchases, sales, trading, swaps, rental and options policies, procedures and internal controls are adequate.
2. To evaluate the ability of the bank's reporting system to adequately monitor compliance to established policies, procedures and limits.
3. To review the bank's reporting system to determine whether it is adequate and effective.
4. To ascertain, to the extent possible, whether LDC trading activities are in compliance with applicable U.S. and local foreign laws.
5. To determine the extent of involvement by committees responsible for LDC trading activity in strategy and planning. For example, have contingency plans been developed if the need arises to liquidate a portfolio of LDC paper.
6. To identify potential conflicts of interest liability between those on committees for debt renegotiations or those acting as agents for the debtor country and those on the portfolio sales personnel and LDC debt traders.
7. To determine whether accounting procedures that have been established properly identify and account for loan sales, purchases, swaps, rentals and other LDC trading activity. Compare these accounting procedures to industry practices.
8. To ascertain that outstandings and traders' positions are reconciled to the official records of the bank.
9. To evaluate the LDC asset purchases, sales, trading, swaps or rentals for profitability.
10. To review the revaluation process utilized in determining profitability.
11. To determine the adequacy of the bank's risk management as it relates to LDC activities. Evaluate the bank's ability to monitor and control the following risks:
  - a. Market risk
  - b. Credit risk
  - c. Settlement risk
  - d. Liquidity risk
  - e. Operational risk
  - f. Legal risk
12. To review and assess the adequacy of the audit coverage with respect to the frequency and scope of the audit program, experience of auditors, quality of audit reports and effectiveness of management follow-up. Determine the extent of the outside accountants involvement in reviewing these activities.
13. To determine if sufficient legal documentation exists to establish an enforceable agreement, and to ascertain the nature of and purpose behind the underlying transaction.
14. To review the bank's procedures for conducting due diligence on nonbank parties.
15. To determine the sufficiency of the bank's transaction files.
16. To determine if the bank allows sales, borrowing or substitutions from its loan portfolio to its trading positions. If yes, how is the pricing on the loan portfolio done? Does the bank have the proper accounting and tracking procedures in place?
17. To review any unusual charges/fees and any split of fees or unusual destination of a payment.
18. To review margin lending practices and policies of banks offering financing to customers dealing in LDC debt.
19. To review bank's policies and procedures regarding traders' ability to trade in LDC debt for their own personal account to ensure that adequate controls are in place to avoid conflicts of interest and diversion of bank's corporate opportunities to traders' personal benefit.

# International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

## Examination Procedures

Effective date September 1992

## Section 7110.3

An examination of a bank's LDC asset purchases, sales, trading, swaps, rental, and options program should focus on written policies, accounting, management reporting, conflict of interest, risk management, and internal controls. In addition, the examiners should address the general nature, volume and importance of these activities.

1. Evaluate the adequacy of the bank's written policies regarding its LDC trading activity and determine whether:
  - a. The objectives, strategy and philosophy adhere to those approved by the bank's board of directors.
  - b. All documentation and legal requirements (both local and foreign) regarding this activity have been addressed.
  - c. An approval process has been established to execute unusual or complex transactions in LDC paper that lacks liquidity or has some unusual feature.
  - d. The policy stipulates the options available if the need arises to remove the asset from inventory.
2. Review the bank's accounting policy for LDC transactions.
  - a. Review the accounting and reporting guidelines to assure that all aspects of this activity are captured on the books of the bank.
  - b. Review the subsidiary ledgers and reconcile these with the general ledger and contingent accounts.
  - c. Reconcile the traders position sheet with the general ledger accounts.
  - d. Review the accounting procedures governing the bank borrowing LDC debt from its own portfolio and purchasing or borrowing from a third party.
  - e. Determine if the revaluation process is conducted separately from the trading process and that the resultant gains or losses are properly recorded.
3. Determine whether the bank has addressed the "conflict of interest" issue sufficiently, so that trading activities are not being influenced by other areas of the bank that may be negotiating debt restructuring activities or that may have provided advice to such country on financial or economic matters. Are the same individuals participating as members of a debt renegotiating committee or acting in an agency capacity for the debtor country also involved in or communicating with those trading, swapping and renting LDC debt?
  - a. Does the policy address all the roles that the bank performs? Has management established procedures to identify the responsibility of renegotiating committee members, agency personnel, portfolio sales personnel and LDC debt traders?
4. Review the bank's procedures to ensure that it is complying with local and sovereign laws.
  - a. Is the bank aware of local and foreign laws governing the trading of a particular country's debt? Are there records demonstrating that legal personnel are reviewing transactions to determine compliance with U.S. and foreign laws? To what extent is this information disseminated to traders?
  - b. Is the bank assuring itself that trading partners are not violating these laws or are using the bank to circumvent compliance with applicable laws and regulations?
5. Evaluate management's understanding of the risks associated with LDC asset purchases, sales, trading, swaps, options and rentals. Determine whether all risks have been considered and assess management's ability to monitor and control them. The following risks should be considered:
  - a. *Market Risk*—The relevant risk interval for counterparty exposure is the time period from trade date to final settlement date. The exposure is a function of the change in the price during the risk interval. Determine how the bank monitors and controls its exposure to an increase in price, if it is buying, and decrease in price, if selling.
  - b. *Credit Risk*—Does the bank require credit approval from appropriate lending officers for each counterparty? Review counterparty credit lines for proper approval.

- Review margin lending practices as related to LDC debt sales.
- c. *Settlement Risk*—While it occurs only when purchasing LDC assets, examiners should determine how the bank protects itself from this risk.
  - d. *Liquidity Risk*—Have restrictions been placed on dealing in LDC debt which is not actively traded?
  - e. *Operating Risk*—Review the bank’s policies and procedures for deficiencies. Assure that all operating groups supporting this activity are adhering to established guidelines.
  - f. *Legal Risk*—Has counsel reviewed all segments of this activity from a legal perspective?
6. Determine whether the bank’s LDC trading activities are subject to regular audits.
    - a. Obtain copies of all recent audits and review their findings;
    - b. Determine whether the audit procedures covering these activities are sufficiently comprehensive; and
    - c. Determine whether management has taken appropriate action to resolve significant audit concerns.
  7. Evaluate the bank’s internal control policies and procedures with emphasis on:
    - a. Are traders’ lines and LDC debt limits established by country, type of paper and customer?
    - b. Are limits established by credit officers who are independent of the LDC trading function?
    - c. Determine that exceptions to established limits have been properly reported and approved.
  8. Evaluate the policies and procedures governing traders’ behavior:
    - a. What type of controls are in place with regard to after hour trading?
    - b. Describe the bank’s procedures for recording phone conversations. Are traders permitted to override the recording devices? How long are these recordings retained?
    - c. Describe the bank’s policy regarding traders’ remuneration.
  - d. What types of procedures and policies have the bank implemented to address self-dealing in LDC debt by traders?
  - e. In what manner are the traders educated about the bank’s policies and procedures?
9. Describe the type of LDC transactions entered into by the bank:
    - a. Does the bank engage in fronting (i.e., sales of participations, etc.) transactions? When engaging in fronting transactions, does the bank conduct the proper legal analysis regarding whether such transaction would violate any U.S. or foreign laws or restructuring agreements? Does the bank inquire as to the customer’s purpose for acquiring LDC debt in fronting transactions?
    - b. Does the bank engage in parking transactions through a third party or another banking unit? Does the bank permit other financial institutions to park debt with it?
  10. Evaluate the private banking unit/group’s involvement in LDC transactions:
    - a. How are the private banking clients obtained?
    - b. What types of LDC transactions does the bank enter into for its private banking clients? Does the bank inquire as to purpose of transactions entered into for private banking clients?
    - c. What type of scrutiny is performed to assure that the bank “knows its private banking clients?”
  11. Describe the types of fees which the bank pays when engaging in LDC transactions:
    - a. What are the amounts of broker fees? Are these fees easily determinable? Are these fees in line with the industry practices?
    - b. Does the bank have any other type of fee arrangements (i.e., specially negotiated fees, partnerships, etc.)?
    - c. Has the bank diversified its use of brokers adequately?
  12. Evaluate broker involvement in the LDC trading activity and review the fee structure on transactions.

# International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

Effective date September 1992

Section 7110.4

## FIRST-DAY LETTER

Please provide the following information regarding your bank's LDC asset sales, purchases, swaps, options, and rental programs as of (*examination date*).

1. A complete inventory, broken down by country, of all LDC paper held in the trading account and the investment account.
2. A listing of all sales/purchases of LDC paper that identifies the assets or commitments sold/bought and inventory by (a) obligor, (b) face amount, (c) maturity, (d) price, (e) closing date, (f) counterparty names, and (g) the names and address of the assignor and assignee.  
Sales from the bank's own portfolio should be reported separately from transactions of the LDC trading unit.
3. Listing of all rentals of and options held on LDC paper.
4. A copy of the bank's specific policies and procedures for LDC asset purchases, sales, swaps, options and rentals.
5. A copy of all rules of conduct, procedures and policies governing LDC activities.
6. An organizational chart and the names and titles of individuals designated as responsible for LDC trading activities.
7. A listing and brief description of all management information reports covering these activities and copies of these reports.
8. Describe accounting policies and operating procedures if the LDC trading unit borrows from the bank's loan portfolio to effect delivery or borrows/lends LDC debt from/to third parties.
9. Information broken down by trading location/profit center showing the volume of LDC assets purchased, sold, swapped and rented during the two prior years, the current year to date and a projection of the volume of activity for the balance of this year and next year.
10. A listing of all limits, including the bank's overall inventory limit, country limits, type of paper limit, customer settlement limit and trader limits. Indicate the policy regarding the review dates of limits. A list of any exception reports to these limits and management's responses to exceptions.
11. A listing of principal counterparties and approved counterparty lines.
12. A list of brokers used and indicate the approximate percentage of total business conducted with each and the fees paid to such brokers.
13. Copies of any standard documents used by the bank in its LDC asset sales, purchases, swaps and rentals.
14. A copy of trading policies. If the bank is a market maker, list the type of LDC debt in which it makes a market.
15. A listing of all general ledger contingency and memoranda accounts, income and expense accounts to record LDC asset sales, swaps and renting transactions.
16. Income and expenses of LDC trading activities for the two prior years and year-to-date.
17. Copies of the most recent audit reports conducted by both the internal and external auditors, including management responses on the bank's LDC asset trading activities.
18. A copy of the internal and external audit programs and procedures used for the audits of these activities.
19. If conducted outside of the United States, any information submitted to local regulatory authorities regarding the LDC trading function should be requested.
20. Copies of any legal opinions rendered on specific transactions and a list of any pending litigations.
21. A copy of the industry association's rules and regulations.

# Statutes and Regulations Administered by the Federal Reserve

Effective date May 2000

## Section 8000.1

Following is a table of statutes and regulations that apply to the Federal Reserve System and to banking institutions that the Federal Reserve Board supervises and regulates. The table consists of five columns:

*Statute.* The name of the law as enacted by Congress and the section.

*U.S. Code citation.* The section of the United States Code where the statute can be found.

*Description.* A summary of the particular section of the statute.

*FRB regulation.* The implementing regulation, usually the Federal Reserve regulation, and the appropriate citation from the Code of Federal Regulations (CFR).

*FRRS locator number.* The location of the statute, regulation, or other reference in the *Federal Reserve Regulatory Service (FRRS)*.

<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Federal Election Campaign Act	2 USC 441b	Limits political contributions by member banks.		
Foreign Gifts and Decorations Act	5 USC 7342	Restricts Board members' and employees' acceptance of foreign gifts and decorations.	Rules Regarding Foreign Gifts and Decorations, 12 CFR 264b	8-610 et seq.
Federal Reserve Act, sec. 10, para. 8	12 USC 1	Issuance of national currency and Federal Reserve notes under general supervision of FRB.		1-084
National Bank Act, as amended by the Banking Act of 1935	12 USC 51b-1	Impairment of the capital of national banks and state member banks.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.4	1-307 3-159
National Bank Act, as amended by the Banking Acts of 1933 and 1935	12 USC 71a	Specific criteria for director selection and qualification for national banks and state member banks.		1-292
Emergency Banking Act of 1933, sec. 4	12 USC 95	Provides the president with power to require member banks to suspend operations during an emergency period.		1-323
Trading with the Enemy Act, sec. 5	12 USC 95a	Provides the president with wartime powers over banking.		1-440 1-441



<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Federal Reserve Act, sec. 1; Banking Act of 1933, sec. 2	12 USC 221, 221a	Definition of basic terms in Federal Reserve Act, including “bank” and “affiliate.”		1-002 1-309
Federal Reserve Act, sec. 2, paras. 1, 2, 3, and 13	12 USC 222–225, 281–282	Federal Reserve Bank organization; requirement that all national banks be members.		1-004 et seq. 1-016
Federal Reserve Act, sec. 2A, para. 1	12 USC 225a	Requires Federal Reserve and the Federal Open Market Committee to— <ul style="list-style-type: none"> <li>• maintain long-run growth of the monetary and credit aggregates to advance the economy’s long-run potential; and</li> <li>• report semiannually to each house of Congress on monetary and credit aggregate ranges.</li> </ul>	Open Market Operations of Federal Reserve Banks, 12 CFR 270	1-017 8-823 et seq.
Federal Reserve Act, sec. 10, paras. 1–7 and 10	12 USC 241–247a	Creation and organization of Board of Governors; qualifications; terms of office; vacancies; assessments on Federal Reserve Banks; construction of Federal Reserve Board building; annual report to Congress; record of FOMC actions.	Rules of Organization	1-077– 1-083 1-086 8-000 et seq.
Federal Reserve Act, sec. 11	12 USC 248	Powers of the Board of Governors.		1-091 et seq.
Federal Reserve Act, sec. 11(a)(1)	12 USC 248(a)(1)	Authorizes Board to examine and require reports of Reserve Banks and member banks.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208	1-092 3-150 et seq.
Federal Reserve Act, sec. 11(a)(2)	12 USC 248(a)(2)	Authorizes Board to require reports from any depository institution as necessary or desirable for monetary control purposes.	Reg D, Reserve Requirements of Depository Institutions, 12 CFR 204.3	1-092 2-159 et seq.
Federal Reserve Act, sec. 11(b)	12 USC 248(b)	Authorizes Board to permit Federal Reserve Banks to rediscount paper of other Federal Reserve Banks and to fix rates of interest for rediscounted paper.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-093 2-001 et seq.

<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Federal Reserve Act, sec. 11(c)	12 USC 248(c)	Authorizes Board to suspend reserve requirements.	Reg D, Reserve Requirements of Depository Institutions, 12 CFR 204	1-094 2-122 et seq.
Federal Reserve Act, sec. 11(d)	12 USC 248(d)	Authorizes Board to supervise and regulate the issue and retirement of Federal Reserve notes through the OCC.		1-095
Federal Reserve Act, sec. 11(m)	12 USC 248(m)	Authorizes Board to fix the percentage of individual member bank capital and surplus that may be represented by loans secured by stock or bond collateral. Limits amount of loans secured by nongovernmental stock or bond collateral to any individual to 15% of bank's capital and surplus.		1-104
Federal Reserve Act, sec. 16, para. 14	12 USC 248-1	Authorizes Board to promulgate regulations for the transfer of funds between Reserve Banks, and to act as or designate Reserve Banks to act as clearinghouses.	Reg J, Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfer Through Fedwire, 12 CFR 210; fee schedules and pricing policies for Federal Reserve Banks	1-153 9-775 et seq.
Federal Reserve Act, sec. 11(e)–(l)	12 USC 248(e)–(l)	Authorizes Board to regulate the affairs of the various Reserve Banks, to delegate its responsibilities to the Reserve Banks, and to hire employees to carry out the Board's business.	Rules Regarding Delegation of Authority, 12 CFR 265	1-096 et seq. 8-102 et seq.
Federal Reserve Act, sec. 11A	12 USC 248a	Requires Federal Reserve to price various services provided by Reserve Banks to depository institutions (e.g., check-collection services, wire transfer of funds, etc.).	Fee Schedules and Pricing Policies for Federal Reserve Banks	1-105 1-105.1
Federal Reserve Act, sec. 11B	12 USC 248b	Requires annual independent audit of financial statements of Federal Reserve Board and Banks.		1-105.5
Federal Reserve Act, sec. 12, paras. 1 and 2	12 USC 261–262	Federal Advisory Council, creation and powers.		1-106 1-107

<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Federal Reserve Act, sec. 12A	12 USC 263	Federal Open Market Committee, creation and powers. Federal Reserve Banks are required to comply with directives.	Federal Open Market Committee, 12 CFR 270-272	1-108 et seq. 8-800 et seq.
Federal Reserve Act, sec. 5, 6, paras. 1 and 2, and sec. 7	12 USC 287-290	Provisions regarding the issuance and cancellation of, and dividends on, Federal Reserve Bank stock.	Reg I, Issue and Cancellation of Capital Stock of Federal Reserve Banks, 12 CFR 209	1-045 et seq. 3-460 et seq.
Federal Reserve Act, sec. 4, paras. 6-22 and 24	12 USC 301-308	Selection, eligibility, duties, and powers of Federal Reserve Bank directors.	Reserve Bank Directors—Actions and Responsibilities, 12 CFR 264a	1-026-1-044 8-168 et seq.
Federal Reserve Act, sec. 4, para. 8	12 USC 301	Suspension of any member bank from use of Federal Reserve credit facilities for undue use of bank credit for speculation or any purpose inconsistent with maintenance of sound credit conditions.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201.6(b)	1-028 2-014
Federal Reserve Reform Act of 1977	12 USC 302	Establishes standards for selection of certain Reserve Bank directors.	Reserve Bank Directors—Actions and Responsibilities, 12 CFR 264a	1-030-1-032
Federal Reserve Act, sec. 9, paras. 1-5	12 USC 321-323	Eligibility requirements for membership in the Federal Reserve System and prohibition against establishment of branch except as authorized for national banks under National Bank Act. Authorizes Board to establish rules and regulations and impose conditions regarding membership.  Provides limits for standby letters of credit and ineligible acceptances and requires disclosure of amount of such credit.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208  Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.24	1-054 et seq. 3-150 et seq.  3-211 et seq.

<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Federal Reserve Act, sec. 9, para. 6	12 USC 324	Applies to state member banks provisions of National Bank Act prohibiting national bank from lending on or purchasing its own stock (as provided in 12 USC 83, Rev. Stat. 5201) and relating to the withdrawal and impairment of the capital stock or payment of dividends (12 USC 55, Rev. Stat. 5205; 12 USC 56, Rev. Stat. 5204; and USC 60, Rev. Stat. 5199). Also authorizes Board to require filing and publication of reports of condition, income, and dividends.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208	1-509 3-150 et seq.
Federal Reserve Act, sec. 9, paras. 7 and 8	12 USC 325–326	Subjects member banks to examination by the Board. Also provides for acceptance of examinations conducted by state authorities.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.64	1-060 1-061 3-380
Federal Reserve Act, sec. 9, paras. 9 and 10	12 USC 327–328	Forfeiture of membership in the System. Withdrawal and cancellation of membership.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.3(f); Reg I, Issue and Cancellation of Capital Stock of Federal Reserve Banks, 12 CFR 209.3	1-062 1-063 3-158 3-463 3-464
Federal Reserve Act, sec. 9, paras. 11 and 12	12 USC 329	Capital requirements for membership including requirement that state member bank have capital at least equal to that of a national bank under 12 USC 51, Rev. Stat. 5138, and 12 USC 51b-1. Prohibition on reduction of capital stock without prior Board approval.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.4	1-064 1-065 3-159
Federal Reserve Act, sec. 9, para. 13	12 USC 330	Laws to which member banks are subject. Provisions regarding the discount of paper of state member bank.		1-066
Federal Reserve Act, sec. 9, para. 14	12 USC 331	Prohibits member bank certification of checks drawn on an account with insufficient funds.		1-067

8000.1 Statutes and Regulations Administered by the Federal Reserve

<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Federal Reserve Act, sec. 9, para. 15	12 USC 332	Provisions authorizing member banks to act as depositaries of public monies.		1-068
Federal Reserve Act, sec. 9, para. 16	12 USC 333	Membership requirements for mutual savings banks.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.3(a)	1-069 3-154
Federal Reserve Act, sec. 9, paras. 17–19	12 USC 334	Reporting requirements for affiliates of member banks and civil money penalty for failure to file.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.3(e)	1-070– 1-072 3-158
Federal Reserve Act, sec. 9, para. 20	12 USC 335	Applies to state member banks the restrictions and prohibitions in National Bank Act regarding the purchase, sale, underwriting, and holding of investment securities and stock (12 USC 24, Seventh, Rev. Stat. 5136).	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.21(b)	1-073 3-202
Federal Reserve Act, sec. 9, para. 21	12 USC 336	Prohibits stapling of stock of a state member bank to that of another corporation.		1-074
Federal Reserve Act, sec. 9, para. 22	12 USC 338	Authorizes Board to examine the affairs of affiliates of state member bank. Refusal to permit examination may cause forfeiture of membership.		1-075
Federal Reserve Act, sec. 9, para. 23	12 USC 338a	Allows state member banks to make investments designed primarily to promote the public welfare.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.22	1-075.1 3-203 et seq.
Federal Reserve Act, sec. 9A	12 USC 339	Prohibits state member banks from participating in lotteries.		1-076
Federal Reserve Act, sec. 4, paras. 4 and 5	12 USC 341	Federal Reserve Bank powers and duties.		1-024 1-025

<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Federal Reserve Act, sec. 13, para. 1	12 USC 342	Authorizes Federal Reserve Banks to receive and collect deposits, checks, drafts, notes, and bills. Also allows member and nonmember banks or other depository institutions to assess reasonable charges, to be determined and regulated by the Board, for collection of checks and other items and transfer of funds.	Reg J, Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire, 12 CFR 210	1-111-9-775 et seq.
Federal Reserve Act, sec. 13, paras. 2–6, 8, 10, 12–14; and sec. 13A, paras. 1–5	12 USC 343–352	Federal Reserve Bank discount and rediscount authority; authorizes Reserve Banks to lend to depository institutions that pledge acceptable collateral and to make advances to member banks, depository institutions, branches and agencies of foreign banks, individuals, partnerships, and corporations. Also authorizes Reserve Banks to discount agricultural paper.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-112–1-116 1-118 1-120 1-122–1-123.1 1-124–1-128 2-001 et seq.
Federal Reserve Act, sec. 14(g)	12 USC 348a	Authorizes Board to exercise supervision over all relationships and transactions between Reserve Banks and foreign banks and bankers.	Reg N, Relations with Foreign Banks and Bankers, 12 CFR 214	7-079.1-7-070 et seq.
Federal Reserve Act, sec. 13A	12 USC 348–352	Various provisions regarding authority of Federal Reserve Banks to discount and extend credit on agricultural paper.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-124–1-128 2-001 et seq.
Federal Reserve Act, sec. 14 (a)–(f)	12 USC 353–359	Authorizes open market operations: Federal Reserve Banks may purchase and sell instruments eligible for use as collateral for discount window transactions. Sets terms and conditions for open market operations. Also authorizes the Secretary of the Treasury to borrow and sell, repurchase, and return U.S. obligations from Reserve Banks in order to meet short-term obligations of the Treasury Department.	Federal Open Market Committee Rules, 12 CFR 270–272, 281	1-129–1-135 8-805 et seq.

<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Federal Reserve Act, sec. 16, para. 13	12 USC 360	Reserve Banks must receive checks and drafts at par. Pricing of services for clearing negotiable instruments.	Reg J, Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire, 12 CFR 210	1-152 9-775 et seq.
Federal Reserve Act, sec. 19(i)	12 USC 371a	Prohibits payment of interest on demand deposits by member banks and authorizes automatic transfer of funds from savings to checking.	Reg Q, Prohibition Against Payment of Interest on Demand Deposits, 12 CFR 217	1-175 2-380 et seq.
Federal Reserve Act, sec. 19(j)	12 USC 371b	Regulates the advertising of interest on time and savings deposits.	Reg DD, Truth in Savings, 12 CFR 230.8	1-176 6-1927 et seq.
Federal Reserve Act, sec. 23	12 USC 371b-2	Requires the Board to prescribe standards to limit the risks posed by exposure of insured depository institutions to other depository institutions.	Reg F, Limitations on Interbank Liabilities, 12 CFR 206	3-040 3-001
Federal Reserve Act, sec. 23A	12 USC 371c	Restrictions on extensions of credit and other covered transactions between affiliates. The Board has rulemaking and exemptive authority.		1-201 et seq. 3-1110 et seq.
Federal Reserve Act, sec. 23B	12 USC 371c-1	Restrictions on transactions with or for the benefit of affiliates. Requires transactions to be conducted on arm's-length terms. The Board has rulemaking and exemptive authority.		1-206.1 et seq.
Federal Reserve Act, sec. 24A	12 USC 371d	Limits investment by member banks in bank premises, and limits loans to or upon the security of the stock of any corporation owning bank premises.		1-216
Federal Reserve Act, sec. 13, para. 7	12 USC 372	Provisions regulating and setting limits on the acceptance of drafts and bills by member banks and U.S. branches and agencies of foreign banks.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-117 et seq. 2-001 et seq.

<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Federal Reserve Act, sec. 19(e)	12 USC 374, 463	Member bank cannot act as agent for nonmember to obtain discount from a Reserve Bank. Also, limits the amount that a member bank can keep on deposit with a depository institution that is not authorized to have access to Federal Reserve advances under 12 USC 347b.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-171 2-001 et seq.
Federal Reserve Act, sec. 19(d)	12 USC 374a	Member bank cannot act as agent for nonbank borrower in making loans on securities to investment securities dealers and brokers.		1-170
Federal Reserve Act, sec. 22(d)	12 USC 375	Provides that member banks may contract for, purchase from, or sell to any of their directors or to a firm of which a director is a member, any securities or other property, provided that the transaction is on terms not less favorable to the bank than those offered to others or when the transaction is approved by a majority of the directors who are not interested parties to the transaction. The Board may require disclosure of such transactions.		1-188 1-189
Federal Reserve Act, sec. 22(g)	12 USC 375a	Imposes lending limits and requirements for loans by member banks to their executive officers. Requires reports by executive officers for indebtedness at other banks.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215	3-1007 et seq. 3-960 et seq.
Federal Reserve Act, sec. 22(h)	12 USC 375b	Lending limits, prior board of directors' approval, and prohibition against preferential lending and overdrafts by member banks to their officers, directors, and principal shareholders and their related interests.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215	3-1011 et seq. 3-960 et seq.
Federal Reserve Act, sec. 22(e)	12 USC 376	Prohibits a member bank from paying to any director, officer, attorney, or employee a greater rate of interest on the deposits of such person than that paid to other depositors on similar deposits with such member bank.		1-190



<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Banking Act of 1933 (Glass-Steagall Act), sec. 21(a)(1)	12 USC 378(a)(1)	Prohibits deposit taking by any person engaged in the business of issuing, underwriting, selling, or distributing securities.		1-311
Banking Act of 1933 (Glass-Steagall Act), sec. 21(a)(2)	12 USC 378(a)(2)	Prohibits any organization from engaging in the business of receiving deposits unless it is authorized to do so by law and is subject to examination.		1-311
Federal Reserve Act, sec. 15; and Act of July 16, 1943, sec. 3	12 USC 391, 392, 395	Authorizes Reserve Banks to act as fiscal agents and depositories of the United States and other organizations.		1-138 1-139 1-280
Federal Reserve Act, sec. 16, paras.1–11	12 USC 411–421	Provides for the issuance, printing, custody, security, and destruction of Federal Reserve notes.		1-140 et seq.
Federal Reserve Act, sec. 16, para. 7	12 USC 417	Provides for custody and safekeeping of notes issued to and collateral deposited with reserve agent.		1-146
Federal Reserve Act, sec. 18	12 USC 441–448	Provides for the issuance, circulation, and redemption of certain bonds and notes of the United States.		1-158 et seq.
Federal Reserve Act, sec. 19(a)–(c), (f)–(h)	12 USC 461, 464–466	Authorizes Board to establish reserve requirements for all depository institutions, to define terms, and to require reporting with respect to the maintenance of reserves.	Reg D, Reserve Requirements for Depository Institutions, 12 CFR 204	1-167– 1-169 1-172– 1-174 2-122 et seq.
Federal Reserve Act, sec. 19(e)	12 USC 463	Limits deposits by member banks with a depository institution without access to Federal Reserve advances.		1-171
Federal Reserve Act, sec. 16, paras. 15–17	12 USC 467	Receipt of gold certificates and SDRs for credit with Federal Reserve System.		1-154 et seq.
Federal Reserve Act, sec. 21, para. 5	12 USC 483	Authorizes Federal Reserve Banks, with the approval of the Board, to provide for special examination of member banks.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.64	1-183 3-380

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Federal Reserve Act, sec. 21, para. 6	12 USC 484	Limits visitatorial powers other than as authorized by law.		1-184
Federal Reserve Act, sec. 21, para. 7	12 USC 485	Provisions relating to the examination of Federal Reserve Banks.		1-185
Federal Reserve Act, sec. 21, para. 9	12 USC 486	Permits Board to waive requirements that affiliates of state member banks either submit reports to state member banks or submit to examination.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.3(e)(2)	1-187 3-158
Revised Statutes sec. 5208	12 USC 501	Prohibits any officer, director, agent, or employee of a Federal Reserve Bank or a member bank from certifying a check drawn on the Federal Reserve Bank or member bank if the drawee has insufficient funds on deposit with the Federal Reserve Bank or member bank to cover the face amount of such check.		1-293
Federal Reserve Act, sec. 2, paras. 6 and 7	12 USC 501a	Provides that penalty for violation of Federal Reserve Act by national bank is forfeiture of charter in a suit brought by the Comptroller at the direction of Board.		1-009 1-010
Federal Reserve Act, sec. 2, para. 4	12 USC 502	Liability of shareholders of Federal Reserve Bank for obligations of the Reserve Bank.		1-007
Federal Reserve Act, sec. 22(f)	12 USC 503	Provides for personal liability of directors and officers of a member bank for a knowing violation of 12 USC 375, 375a, 375b, 376 (Federal Reserve Act, sections 22(d), (e), (g), and (h)) or regulations of the Board made under authority thereof and various provisions of title 18 (Criminal Code).		1-191
Federal Reserve Act, sec. 29	12 USC 504	Civil money penalty provision for violation by member bank of sections 22 and 23A of the Federal Reserve Act.	Rules of Practice for Hearings, 12 CFR 263, section 263.1(e) and subpart C	1-262 et seq. 8-044 8-086.3 et seq.

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Federal Reserve Act, sec. 19(l)(1)	12 USC 505	Civil money penalty provisions for violation by member bank of section 19 of the Federal Reserve Act.	Rules of Practice for Hearings, 12 CFR 263, section 263.1(e)(2) and subpart C	1-177 8-044 8-086.3 et seq.
Federal Reserve Act, sec. 3; and sec. 10, para. 9	12 USC 521–522	Provisions regarding Federal Reserve Bank branches and buildings.		1-018 et seq. 1-085
Federal Reserve Act, sec. 7(c)	12 USC 531	Exempts Federal Reserve Banks from federal, state, and local taxes except on real property.		1-050
Federal Reserve Act, sec. 25	12 USC 601–604a	Authorizes national banks to establish foreign branches; to invest in foreign banks; and to invest in corporations engaged in international banking. These provisions apply to state member banks through 12 USC 335 and 321 (Federal Reserve Act, sec. 9, para. 20 and para. 3).	Reg K, International Banking Operations, subpart A, 12 CFR 211	1-217 et seq. 3-587 et seq.
Federal Reserve Act, sec. 25A (Edge Act)	12 USC 611–631	Authorizes member banks and foreign banks to establish corporations to engage in international banking and finance (Edge Act corporations); such corporations may conduct international banking operations through offices in the United States and overseas and may invest in foreign organizations. Edge corporations are subject to reserve requirements of Regulation D (12 CFR 204), limitations on interest on deposits of Regulation Q (12 CFR 217), and the Board's margin limitations.	Reg K, International Banking Operations, 12 CFR 211, subpart A	1-227 et seq. 3-587 et seq.
Federal Reserve Act, sec. 25B	12 USC 632	Governs disposition of property of a foreign state held by a Federal Reserve Bank; gives federal courts original jurisdiction over all civil suits involving Federal Reserve Banks or corporations engaged in international banking.	Reg N, Relations with Foreign Banks and Bankers, 12 CFR 214	1-252 et seq. 7-070 et seq.
Home Owners' Loan Act of 1933	12 USC 1470	Authorizes Board to regulate investment by state member banks in state housing corporations.		1-297.1 1-297.2

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National Housing Act of 1934, sec. 303(d)	12 USC 1718(d)	Authorizes insured banks to invest in the stock of the Federal National Mortgage Association.		1-298
National Housing Act of 1934	12 USC 1735f-5	Prohibits discrimination based on sex in the making of a federally related mortgage or loan. The combined income of spouses shall be considered in determining whether or not to extend mortgage credit.		
Federal Deposit Insurance Act, sec. 4(b)	12 USC 1814(b)	Requires state member banks that accept deposits to obtain insurance.		1-337
Federal Deposit Insurance Act, sec. 7(a)(3)	12 USC 1817(a)(3)	Requires quarterly reports of condition for insured banks to ensure safety and soundness.		1-341
Change in Bank Control Act, (Federal Deposit Insurance Act sec. 7(j))	12 USC 1817(j)	Requires prior notice to the appropriate agency for a proposed change in control of an insured bank or bank holding company. Establishes disapproval criteria and provides for civil money penalties for violations. Requires reports on loans secured by 25% or more of the stock of another insured bank.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225, subpart E	1-344 et seq. 4-051.8 et seq.
Federal Deposit Insurance Act, sec. 7(k)	12 USC 1817(k)	Reporting and public disclosure by insured banks of information concerning extensions of credit by the bank to its officers and principal shareholders and their related interests.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215, subpart B	3-1025 3-987 et seq.
Federal Deposit Insurance Act, sec. 8(b)-(n)	12 USC 1818(b)-(n)	Cease-and-desist authority over state member banks, bank holding companies, and their nonbank subsidiaries, Edge and agreement corporations, and foreign banks with state agencies or uninsured branches in the United States, and officers, directors, employees, agents, or others for violations of law or unsafe or unsound practices.	Rules of Practice for Hearings, 12 CFR 263	1-356 et seq. 8-043 et seq.

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Federal Deposit Insurance Act, sec. 8(e)	12 USC 1818(e)	Authorizes suspension, removal, or prohibition from participation of parties affiliated with state member banks, bank holding companies, and other institutions under the Board's jurisdiction for violations of law or unsafe or unsound practices.	Rules of Practice for Hearings, 12 CFR 263, subpart A	1-363 et seq. 8-043 et seq.
Federal Deposit Insurance Act, sec. 8(g)	12 USC 1818(g)	Authorizes suspension, removal, or prohibition from participation of parties affiliated with a state member bank who is charged with a felony.	Rules of Practice for Hearings, 12 CFR 263, subpart D	1-369 et seq. 8-086.9 et seq.
Federal Deposit Insurance Act, sec. 8(i)	12 USC 1818(i)	Provides for civil money penalty of up to \$5,000 per day for violation of an order issued under 12 USC 1818(b), (c), (e), (g), or (s). Also provides for enforcement of an order.	Rules of Practice for Hearings, 12 CFR 263, subparts A and C	1-374 et seq. 8-043 et seq. 8-086.3 et seq.
Federal Deposit Insurance Act, sec. 8(r)	12 USC 1818(r)	Provides for removal of an officer, director, employee, or agent of a foreign bank for a violation of law or unsafe or unsound practice in the United States.	Rules of Practice for Hearings, 12 CFR 263, subpart A	1-383.1 et seq. 8-043 et seq.
Federal Deposit Insurance Act, sec. 10(c) and (d)	12 USC 1820(c) and (d)	Authorizes taking of testimony under oath and the issuance of subpoena in connection with bank examination.		1-385 1-385.01
Federal Deposit Insurance Act, sec. 13(f); Bank Holding Company Act of 1956, sec. 3(d)	12 USC 1823(f) and 1842(d)	Permits a bank holding company to acquire a failing bank in a state outside its principal state of banking operations.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.13(c)	1-385.2 et seq. 4-069 4-024
Bank Merger Act of 1966	12 USC 1828(c)	Requires prior written agency approval for any insured bank merger or consolidation or the acquisition of assets by an insured bank. Establishes uniform approval standards and notice requirements.		1-386 et seq.
Federal Deposit Insurance Act, sec. 18(i)	12 USC 1828(i)	Requires prior written approval of the appropriate agencies for an insured bank to convert to an insured state bank if the bank will reduce or retire stock as part of the conversion.		1-396 1-397

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Federal Deposit Insurance Act, sec. 19	12 USC 1829	Prohibition against service, without FDIC approval, as director, officer, or employee of an insured bank upon conviction for crime involving dishonesty or breach of trust.		1-398.5 et seq.
Bank Secrecy Act of 1970; Currency and Foreign Transactions Reporting Act of 1978	12 USC 1829b 12 USC 1951–1959 31 USC 5311–5330	Requires insured banks and uninsured banks to maintain records on identities of account holders; requires reproductions or microfilm of checks and other instruments drawn on or presented to it, and other records for use in criminal, tax, or regulatory investigations. Requires the maintenance of appropriate types of records and the making of appropriate reports by businesses in the United States when records or reports have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.	Financial Recordkeeping and Reporting of Currency and Foreign Transactions, 31 CFR 103 (Treasury reg)	3-1700 et seq.
Federal Deposit Insurance Act, sec. 38	12 USC 1831o	Prompt corrective action—defines the capital measures and capital levels used for determining supervisory actions.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.40	1-400.4 et seq. 3-325 3-326
Federal Deposit Insurance Act, sec. 39	12 USC 1831p-1	Safety-and-soundness standards. Requires banking agency to prescribe standards relating to banking operations, asset quality, earnings, and executive compensation.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208, app. D-1	1-401 et seq. 3-1579.3
Consumer Checking Account Equity Act of 1980; Federal Reserve Act, sec. 19(i)	12 USC 1832, 371a	Authorizes depository institutions to offer NOW accounts and automatic transfers from savings to checking.		1-175
Bank Holding Company Act of 1956	12 USC 1841 et seq.	Governs acquisition of bank stock by companies and provides generally for the separation of banking and commerce by restricting the activities in which bank affiliates may engage.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225	4-001 et seq.

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Bank Holding Company Act of 1956, sec. 2(h)(2); International Banking Act of 1978	12 USC 1841(h)(2) 12 USC 3101 et seq.	Permits foreign banks that are subject to the International Banking Act to hold shares of a foreign nonbanking company that engages in business in the United States, provided that the U.S. activities are in the same line of business as the foreign activities of the foreign nonbank company. Exemption does not extend to securities activities or banking or financial operations.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.22(h); Reg K, International Banking Operations, 12 CFR 211, subpart B	4-064 4-037 1-562 et seq. 3-671 3-630 et seq.
Bank Holding Company Act of 1956, sec. 3	12 USC 1842	Requires prior Board approval to become a bank holding company; to acquire more than 5% of another bank; to merge or consolidate bank holding companies. Requires notice of filing of applications to other regulators. Prohibits interstate acquisitions except in the case of failing institutions under 12 USC 1823(f) or where state law permits.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225, subpart B	4-066 et seq. 4-018 et seq.
Bank Holding Company Act of 1956, sec. 4	12 USC 1843	Generally prohibits acquisition of more than 5% of the shares of a nonbank company. Exceptions include shares of kind eligible for investment by national banks; and where Board finds the activities to be so closely related to banking as to be a proper incident thereto. The Board has delineated over 20 activities as closely related to banking.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225, subpart B	4-071 et seq. 4-018 et seq.
Bank Holding Company Act of 1956, sec. 4(a)(2)	12 USC 1843(a)(2)	Provides grandfather rights for non-banking activities commenced before June 30, 1968.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.22(g)	4-071 4-072 4-037
Bank Holding Company Act of 1956, sec. 4(c)(9)	12 USC 1843(c)(9)	Permits Board to grant further non-banking exemptions to foreign banks if the exemptions are not substantially at variance with the purposes of the act and are in the public interest.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.22(h); Reg K, International Banking Operations, 12 CFR 211, subpart B	4-078 4-037 et seq. 3-630 et seq.

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Bank Holding Company Act of 1956 sec. 4(c)(13)	12 USC 1843(c)(13)	Permits bank holding companies to acquire foreign companies that do no business in the United States except as an incident to their foreign business.	Reg K, International Banking Operations, 12 CFR 211.5	4-080 3-609 et seq.
Bank Holding Company Act of 1956, sec. 4(c)(14)	12 USC 1843(c)(14)	Permits bank holding companies to invest in export trading companies, i.e., companies exclusively engaged in matters relating to international trade and principally engaged in exporting.	Reg K, International Banking Operations, 12 CFR 211, subpart C	4-080.1 3-649 et seq.
General authority to consider safety and soundness		Prohibits redemption of bank holding company equity securities under certain circumstances without prior notice to Board in order to prevent unsafe or unsound reductions of capital.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.4(b)	4-013 et seq.
Bank Holding Company Act sec. 4(k)-(o)	12 USC 1843(k)-(o)	Permits bank holding companies and foreign banks that qualify as financial holding companies to engage in securities, insurance, and other activities that are financial in nature or incidental to a financial activity and to make merchant banking investments.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225, subparts I and J	4-082.7 et seq. 4-056 et seq.
Bank Holding Company Act of 1956, sec. 5(a)-(d), (f)	12 USC 1844	Requires bank holding companies to register with Board and authorizes Board to issue regulations to carry out the purposes of the act, to require reports and conduct examinations of bank holding companies and their subsidiaries, and to take depositions and subpoena documents.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225; Rules of Practice for Hearings, 12 CFR 263	4-083- 4-085 4-088 4-001 et seq. 8-043 et seq.
Bank Holding Company Act of 1956, sec. 5(e)	12 USC 1844(e)	Authorizes Board to require divestiture of nonbank subsidiaries or termination of nonbank activity if the Board determines that the subsidiary or activity constitutes a serious risk to the financial safety and soundness or stability of bank holding company.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.4(a)	4-086 4-087 4-012
Bank Holding Company Act Amendments of 1970, sec. 106(b)	12 USC 1972	Prohibition against tie-in arrangements by banks. The Board has rulemaking and exemptive authority.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.7	4-147 et seq. 4-017.1 4-017.2



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Bank Holding Company Act Amendments of 1970, sec. 106(b)(2)	12 USC 1972(2)	Prohibits preferential extensions of credit by insured banks based on correspondent account relationships.	Reg O, Loans to Executive Officers, Directors and Principal Shareholders of Member Banks, 12 CFR 215, subpart B	3-1018 et seq. 3-987 et seq.
Bank Holding Company Act Amendments of 1970, sec. 106(b)(2)(G)(i)	12 USC 1972(2)(G)(i)	Reporting and public disclosure requirements for executive officers and principal shareholders of insured banks with respect to extensions of credit from correspondent banks.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215, subpart B	3-1023 et seq.
Bank Holding Company Act Amendments of 1970, sec. 106(b)(2)(G)(ii)	12 USC 1972(2)(G)(ii)	Reporting and public disclosure requirements for insured banks regarding extensions of credit by correspondent banks to the reporting bank's officers and principal shareholders.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215, subpart B	3-1024 et seq.
Bank Service Company Act, sec. 1-7	12 USC 1861-1867	Permits insured banks to invest in a corporation that provides services for depository institutions; and, with the prior approval of the agency, in a bank service company that provides services to others that are authorized for its bank parent(s) only at locations where its bank parent(s) may perform such services.		1-324 et seq.
Bank Service Company Act, sec. 5	12 USC 1865	Requires prior Board approval for a member bank to invest in a bank service company that performs services permissible for bank holding companies under section 4(c)(8) of the BHC Act and at any geographic location other than where its parent could perform the service.		1-327.1

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Bank Protection Act of 1968, sec. 2-5	12 USC 1881-1884	Requires establishment of standards for installation, maintenance, and operation of bank security devices and procedures. Requires annual reports of compliance and appointment of a security officer.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.61	1-472 et seq. 3-371 et seq.
Credit Control Act	12 USC 1901-1909	Permits Board, upon authorization by the president, to regulate and control all extensions of credit, and to require reports regarding any extensions of credit. Authorizes imposition of civil money penalties on any person who violates the regulations or fails to report as required. (Expired June 30, 1982.)		1-535 et seq.
Real Estate Settlement Procedures Act	12 USC 2601-2617	Requires disclosure of all costs associated with purchases of real estate and prohibits payments of kickbacks and unearned fees in any transaction concerning a federally related mortgage.	Real Estate Settlement Procedures, 24 CFR 3500 (HUD reg)	6-1350 et seq. 6-1370 et seq.
Home Mortgage Disclosure Act	12 USC 2801-2811	Requires reports and public disclosure of the number and amount of mortgage loans made by depository institutions within a geographic area by census tract.	Reg C, Home Mortgage Disclosure, 12 CFR 203	6-228 et seq. 6-200 et seq.
Community Reinvestment Act	12 USC 2901-2905	Requires federal financial supervisory agencies to examine depository institutions to determine whether such institutions are meeting the credit needs of their communities; and requires such agencies to consider the records of such institutions in meeting community credit needs in acting on applications by such institutions for additional deposit facilities.	Reg BB, Community Reinvestment, 12 CFR 228	6-1247 et seq. 6-1220 et seq.
International Banking Act of 1978, sec. 1	12 USC 3101	Foreign banks required to designate a home office if they do not have deposit-taking offices. The Riegle-Neal Interstate Banking Act of 1994 removed geographic restrictions on interstate banking by foreign banks.	Reg K, International Banking Operations, 12 CFR 211.22	1-562 et seq. 3-633

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International Banking Act of 1978, sec. 5	12 USC 3103	Restricts the U.S. expansion of a foreign bank's deposit-taking capabilities across state lines; provides for establishment of limited branches that accept only those deposits permissible for an Edge corporation; and imposes prohibition contained in section 3(d) of the Bank Holding Company Act on acquisition of bank assets or shares outside the foreign bank's home state.	Reg K, International Banking Operations, 12 CFR 211, subpart B	1-565 et seq. 3-630 et seq.
International Banking Act of 1978, sec. 7(a)	12 USC 3105(a)	Subjects U.S. branches and agencies of foreign banks to reserve requirements and prohibition against payment of interest on demand deposits.	Reg D, Reserve Requirements of Depository Institutions, 12 CFR 204; Reg Q, Prohibition Against Payment of Interest on Demand Deposits, 12 CFR 217	1-567 et seq. 2-380 et seq.
International Banking Act of 1978, sec. 7(c); Federal Reserve Act, sec. 13, para. 14	12 USC 3105(c) 12 USC 347d	Gives Board authority to examine each U.S. branch, agency, or commercial lending company of a foreign bank. Requires each branch or agency to submit quarterly Reports of Condition. Subjects branches and agencies to prohibitions on underwriting and dealing in securities.		1-569 1-123.1
International Banking Act of 1978, sec. 8	12 USC 3106	Subjects foreign bank with a U.S. branch, agency, commercial lending company, or subsidiary bank to the Bank Holding Company Act; grandfathers certain activities and investments of foreign banks; prohibits tie-in arrangements under section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 USC 1972).	Reg K, International Banking Operations, 12 CFR 211, subpart B	1-571 et seq. 3-630 et seq.
		Foreign banks permitted to establish U.S. representative offices without filing a formal application.	Reg K, International Banking Operations, 12 CFR 211.24	3-648.1

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		Criteria for “well-managed.”	Reg K, International Banking Operations, 12 CFR 211.5	3-609 et seq.
		Criteria for evaluating the U.S. operations of foreign banks that the Board determines are not subject to comprehensive consolidated supervision or regulation.	Reg K, International Banking Operations, 12 CFR 211.30	3-648.7 et seq.
International Banking Act of 1978, sec. 9(b)	12 USC 3106a	Prohibits discrimination by U.S. offices of foreign banks and requires disapproval of applications by such foreign banks if banks do not agree to comply with antidiscrimination laws.		1-573.1
Depository Institutions Management Interlocks Act	12 USC 3201–3208	Prohibits management official interlocks between two depository organizations if they are not affiliated and are either very large or located in the same local area.	Reg L, Management Official Interlocks, 12 CFR 212	3-801 et seq. 3-775 et seq.
Federal Financial Institutions Examination Council Act	12 USC 3301–3308	Establishes a council to prescribe uniform principles, standards, and report forms for examination of financial institutions and to promote uniformity in other supervisory matters.	12 CFR 1101 (FFIEC reg)	
Right to Financial Privacy Act	12 USC 3401–3422	Establishes standards under which a federal government agency may obtain, and a financial institution may provide, information contained in financial records of a customer of the financial institution. Provides for cost reimbursement to institution for furnishing records of customers.	Reg S, Reimbursement to Financial Institutions for Assembling or Providing Financial Records, 12 CFR 219	6-1750 et seq. 3-1200 et seq.
Garn–St Germain Depository Institutions Act of 1982, sec. 204	12 USC 3503	Establishes a deposit account directly equivalent to a money market mutual fund and exempts such account from transaction account reserves, section 19(b) of the Federal Reserve Act (12 USC 461).	Reg D, Reserve Requirements of Depository Institutions, 12 CFR 204.2(d)(2)	2-138.1
Truth in Savings Act	12 USC 4301 et seq.	Requires clear and uniform disclosures about deposit accounts.	Reg DD, Truth in Savings, 12 CFR 230	6-1900 et seq.

<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Federal Deposit Insurance Corporation Improvement Act, sec. 401–407	12 USC 4401–4407	Validates netting contracts among financial institutions and expands definition of “financial institution.”	Payments System Risk Policy; Reg EE, Netting Eligibility for Financial Institutions, 12 CFR 231	9-1500 et seq. 9-1000 et seq. 9-1475 et seq.
Clayton Antitrust Act, sec. 7 and 8	15 USC 18, 19	Prohibits mergers, acquisitions, and similar transactions between banks that substantially lessens competition. Prohibits certain interlocking bank directorates.		1-404 et seq.
Robinson-Patman Anti-Discrimination Act, sec. 11	15 USC 21	Authorizes Board to take enforcement action against banks for discrimination in price, services, and facilities.		1-407 et seq.
Federal Trade Commission Act, sec. 18(f)	15 USC 57a(f)	Authorizes Board to adopt rules prohibiting unfair or deceptive acts or practices by banks and to take regulatory action to prohibit those acts or practices on its own motion and to mirror comparable rules adopted by Federal Trade Commission.	Reg AA, Unfair or Deceptive Acts or Practices, 12 CFR 227	6-1203 6-1204 6-1200 et seq.
Securities Exchange Act of 1934, sec. 17A	15 USC 78q-1	Provides for the registration of state member banks acting as transfer agents and municipal securities dealers; establishes procedure for registration and withdrawal of transfer agents and municipal securities dealers and sets forth enforcement authority over clearing agents, transfer agents, and municipal securities dealers.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208, subpart C	5-173 et seq. 3-250 et seq.
Securities Exchange Act of 1934	15 USC 78b, 78c, 78i, 78j, 78l, 78p, 78r, 78t, 78u, 78w, 78x, 78aa, 78bb, 78dd, 78ff	Regulates transactions in bank securities to prevent unfair or manipulative practices, requires reports by publicly held banks, including securities registration statements, proxy statements, and periodic financial statements and reports by officers and directors regarding their shareholdings.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.36	5-001 et seq. 3-285 et seq.

<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Securities Exchange Act of 1934, sec. 7 and 8	15 USC 78g, 78h	Authorizes Board to regulate amount of credit that may be extended to finance securities transactions; makes it unlawful for brokers, dealers, members of exchanges, or other persons to extend credit for the purpose of purchasing or carrying securities without complying with rules issued by the Board. Also makes it unlawful for any person to obtain an extension of credit in the United States or for a U.S. person or a foreign person controlled by or acting on behalf of a U.S. person to purchase various types of securities without complying with rules issued by the Board. Makes it unlawful for any registered broker, dealer, or member of a national securities exchange to (1) borrow on any registered security except from specified classes of banks, (2) arrange for the hypothecation of customer securities in contravention of Board rules, and (3) lend or arrange for the lending of a customer's securities in contravention of Board rules.	Reg T, Credit by Brokers and Dealers, 12 CFR 220; Reg U, Credit by Banks or Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stocks, 12 CFR 221; Reg X, Borrowers of Securities Credit, 12 CFR 224	5-049 et seq. 5-392 et seq. 5-745 et seq. 5-970 et seq.
Securities Exchange Act of 1934, sec. 30A and 30B	15 USC 78dd-1, 78dd-2	Prohibits an issuer of securities registered under the Securities Exchange Act from giving anything of value to a foreign official to influence any act or decision of said official. Banking agencies have determined that such actions are considered unsafe and unsound practices.		5-248 et seq.
Public Utility Holding Company Act	15 USC 79q	Prohibits director and officer interlocks between a public utility holding company and a bank without SEC approval.		
Investment Company Act of 1940, sec. 10(c)	15 USC 80a-10	Prohibits a registered investment company from having a majority of its board of directors consist of officers, directors, or employees of any one bank.		5-262
Small Business Act, sec. 6	15 USC 635(a)	Authorizes Federal Reserve Banks to act as fiscal agents for the Small Business Administration.		1-277

<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Small Business Investment Act, sec. 302	15 USC 682	Authorizes member banks to invest in Small Business Investment Companies up to 5% of bank's capital and surplus.		1-299
Truth in Lending Act	15 USC 1601–1646	Requires creditors to disclose to consumers the cost and terms of credit; gives consumers the right to cancel certain credit transactions; regulates credit card issuance and liability; prescribes certain requirements for advertising credit.	Reg Z, Truth in Lending, 12 CFR 226 (covers all creditors)	6-1030 et seq. 6-600 et seq.
Fair Credit Billing Act	15 USC 1666–1666j	Provides for fair and timely resolution of credit billing disputes; regulates certain credit card practices.	Reg Z, Truth in Lending, 12 CFR 226 (covers all creditors)	6-1109 et seq. 6-600 et seq.
Consumer Leasing Act	15 USC 1667–1667e	Requires accurate disclosure of consumer leasing terms; limits lessee liability; prescribes certain requirements for advertising consumer leases.	Reg M, Consumer Leasing, 12 CFR 213 (covers all lessors)	6-550 et seq. 6-500 et seq.
Fair Credit Reporting Act	15 USC 1681–1681t	Protects consumers against inaccurate or misleading information in credit files maintained by credit bureaus; requires these bureaus to allow credit applicants to correct erroneous reports.		6-1550 et seq.
Equal Credit Opportunity Act	15 USC 1691–1691f	Prohibits credit discrimination on the basis of race, color, religion, national origin, sex, marital status, or age or because of receipt of public assistance or exercise of rights under the consumer Credit Protection Act; requires creditors to notify applicants of action taken on the application.	Reg B, Equal Credit Opportunity, 12 CFR 202 (covers all creditors)	6-091 et seq. 6-001 et seq.
Equal Credit Opportunity Act, sec. 703(b)	15 USC 1691b	Authorizes Board to establish a Consumer Advisory Council to advise and consult with the Board on the Consumer Credit Protection Act and other consumer-related matters.	Rules of Organization and Procedure of the Consumer Advisory Council, 12 CFR 267	6-100 et seq. 6-2500 et seq.
Fair Debt Collection Practices Act	15 USC 1692	Prohibits the use of abusive, deceptive, and unfair debt collection practices by third-party debt collectors.		6-1675 et seq.

<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Electronic Fund Transfer Act	15 USC 1693–1693r	Prescribes disclosure and documentation requirements for institutions involved in electronic funds transfers; requires prompt resolution of errors on electronic transfer accounts; limits customer liability for unauthorized use of EFT card.	Reg E, Electronic Fund Transfers, 12 CFR 205	6-359 et seq. 6-300 et seq.
Emergency Loan Guarantee Act	15 USC 1841–1852	Creates the Emergency Loan Guarantee Board (composed of the secretary of the Treasury, chairman of the Federal Reserve Board, and chairman of the SEC) to guarantee loans for borrowers whose failure would adversely affect the economy. (Authority to enter into a guarantee ended 12/31/73.)		1-548 et seq.
Emergency Loan Guarantee Act, sec. 10	15 USC 1849	Authorizes Federal Reserve Banks to act as fiscal agents for the Loan Guarantee Board.		1-558
Criminal Code sec. 208	18 USC 208	Establishes standards of conduct for Reserve Bank directors in the exercise of their duties.	Reserve Bank Directors—Actions and Responsibilities, 12 CFR 264a	8-168 et seq.
Act of June 25, 1948	18 USC 212–215, 655, and 1906	Prohibits the offering of or acceptance by a bank examiner of a loan or gratuity, as well as theft or disclosure of confidential banking data by a bank examiner. Also prohibits bank officers, directors, employees, agents, or attorneys from receiving payment for procuring or attempting to procure a loan or extension of a loan for a third party.		1-451 et seq. 1-456 1-465
Bank Bribery Act	18 USC 215	Proscribes corrupt activity within financial institutions. Federal Reserve guidelines issued by the Board on October 21, 1987 (SR-87-36) inform state member banks and bank holding companies to develop codes or policies to alert bank or bank holding company officials about the bank bribery statute, as well as to establish and enforce standards relating to acceptable business practices.		1-454 3-1504



<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Various statutes	22 USC 282d, 283d, 284d, 285d, 290g-5, 290i-5	Authorizes Reserve Banks to act as depositories and/or fiscal agents for various agencies, such as the International Finance Corporation, Inter-American Development Bank, International Development Association, Asian Development Bank, African Development Fund, and African Development Bank.		9-839 et seq.
Bretton Woods Agreements Act, sec. 4	22 USC 286b	Authorizes the chairman of the Board and others to establish the National Advisory Council on International Monetary and Financial Problems.		1-477– 1-480
Bretton Woods Agreements Act, sec. 6	22 USC 286d	Authorizes Reserve Banks to act as fiscal agents or as a depository for the IMF and the International Bank for Reconstruction and Development.		9-836
Bretton Woods Agreements Act, sec. 8	22 USC 286f and Exec. Order 10033	Authorizes Board to require persons, by subpoena or otherwise, to provide information at the request of the president.		1-484 1-485
Special Drawing Rights Act of 1968	22 USC 286p	Authorizes issuance of special drawing rights to Reserve Bank.		1-290
Internal Revenue Code	26 USC 5703, 6302	Authorizes Reserve Banks to receive taxes imposed on tobacco products, any other tax under Internal Revenue laws, or state individual income taxes.		1-269
Bank Secrecy Act of 1970; Currency and Foreign Transactions Reporting Act of 1978	31 USC 5311– 5322	Requires persons and financial institutions involved in the transmission of funds exceeding specified amounts to or from the United States to file reports with the secretary of the Treasury in order to further enforcement of criminal, tax, or other investigatory proceedings.	Financial Recordkeeping and Reporting of Currency and Foreign Transactions, 31 CFR 103 (Treasury reg)	3-1700 et seq. 3-1760 et seq.
Fair Housing Act	42 USC 3601– 3619	Prohibits discrimination on the basis of race, color, religion, sex, or national origin in housing-related transactions; requires agencies to administer housing-related activities and programs in a way that affirmatively promotes the purposes of the act.		6-1450 et seq.

<i>Statute</i>	<i>U.S. Code Citation</i>	<i>Description</i>	<i>FRB Regulation</i>	<i>FRRS Locator Number</i>
Flood Disaster Protection Act; National Flood Insurance Act	42 USC 4003, 4012a, 4104a, 4106, 4128	Prohibits federally regulated lending institutions from making any loan secured by improved real estate or a mobile home located in designated flood hazard areas unless the property is covered by flood insurance. Also prohibits lending by such institutions in designated flood hazard areas without prior notice to purchasers of such property.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.25	1-331 et seq. 3-213 et seq.
Defense Production Act of 1950	50 App. USC 2091, 2152 et seq. Exec. Order 12919	Authorizes Board to establish interest rates, fees, and other charges on federally guaranteed loans for defense production under the act or executive order. Authorizes Federal Reserve Banks to act as fiscal agents for any guaranteeing agency, under the supervision of the Board.		

## REFERENCE TABLE OF FEDERAL RESERVE ACT SECTIONS

<i>U.S. Code Title 12, Section</i>	<i>Federal Reserve Act, Section</i>	<i>U.S. Code Title 12, Section</i>	<i>Federal Reserve Act, Section</i>	<i>U.S. Code Title 12, Section</i>	<i>Federal Reserve Act, Section</i>	<i>U.S. Code Title 12, Section</i>	<i>Federal Reserve Act, Section</i>
1	10, ¶8	307	4, ¶22	359	14(f)	467	16, ¶¶15–17
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245	10, ¶5	336	9, ¶21	391	15, ¶1	603	25, ¶8
246	10, ¶6	338	9, ¶22	392	15, ¶2	604	25, ¶9
247	10, ¶7	338a	9, ¶23	393	15, ¶3	604a	25, ¶10
247a	10, ¶10	339	9A	411	16, ¶1	611	25A, ¶1
248	11	341	4, ¶¶4, 5	412	16, ¶2	611a	25A, ¶13
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248a	11A	343	13, ¶¶2, 3	414	16, ¶4	613	25A, ¶3
248b	11B	344	13, ¶4	415	16, ¶5	614	25A, ¶4
261	12, ¶1	345	13, ¶5	416	16, ¶6	615	25A, ¶¶5–9
262	12, ¶2	346	13, ¶6	417	16, ¶7	616	25A, ¶10
263	12A	347	13, ¶8	418	16, ¶8	617	25A, ¶11
281	2, ¶13	347a	10A	419	16, ¶9	618	25A, ¶12
282	2, ¶3	347b	10B	420	16, ¶10	619	25A, ¶13
283	2, ¶9	347c	13, ¶13	421	16, ¶11	620	25A, ¶14
284	2, ¶10	347d	13, ¶14	441	18, ¶1	621	25A, ¶15
285	2, ¶11	348	13A, ¶1	442	18, ¶¶2, 3	622	25A, ¶16
286	2, ¶12	348a	14(g)	443	18, ¶4	623	25A, ¶17
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289	7, ¶1	351	13A, ¶4	446	18, ¶7	626	25A, ¶20
290	7, ¶2	352	13A, ¶5	447	18, ¶8	627	25A, ¶21
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303	4, ¶¶13–15	355	14(b)	463	19(e)	630	25A, ¶24
304	4, ¶¶16–19	356	14(c)	464	19(f)	631	25A, ¶25
305	4, ¶20	357	14(d)	465	19(g)	632	25B
306	4, ¶21	358	14(e)	466	19(h)	633	25C

\* Not codified to the Federal Reserve Act.

# Internal Control: Supplement on Internal Auditing

Effective date May 2006

## Section A.1010.1

The information in the first part of this section is reprinted from a publication of the Bank Administration Institute (BAI), entitled "Statement of Principle and Standards for Internal Auditing in the Banking Industry." The second part of this section reproduces appendixes A and B from the February 9, 2006, Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters. (See section 1010.1 of this manual.)

### A STATEMENT OF PRINCIPLE CONCERNING INTERNAL AUDITING IN THE BANKING INDUSTRY

Internal auditing is that management function which independently evaluates the adequacy, effectiveness and efficiency of the systems of control within an organization and the quality of ongoing operations.

The systems of control comprise the plan of organization and all methods and measures designed to:

- Provide reasonable assurance that assets are safeguarded, information (financial and other) is timely and reliable, and errors and irregularities are discovered and corrected promptly.
- Promote operational efficiency.
- Encourage compliance with managerial policies, laws, regulations, and sound fiduciary principles.

Ongoing operations comprise all activities involved in the conduct of the organization's business.

The internal auditor is accountable to the board of directors and executive management. This accountability precludes the auditor from organizational relationships that may conflict with the need for independence.

### STANDARDS OF INTERNAL AUDITING IN THE BANKING INDUSTRY

#### Organization Standards

1. The organization shall have an internal audit function responsible for evaluating the adequacy, effectiveness and efficiency of its systems of control and the quality of ongoing operations.
2. The organization shall maintain an environment within which the auditor has the freedom to act.
3. The organization shall allocate sufficient resources to the audit function to enable it to conform to the standards of internal auditing.
4. The organization shall require management to respond formally to adverse audit findings and to take appropriate corrective action.
5. The organization's systems of control shall include measurement of audit effectiveness and efficiency.

#### Personal Standards

1. An internal auditor shall have adequate technical training and proficiency.
2. An internal auditor shall maintain a sufficiently independent state of mind to clearly demonstrate objectivity in matters affecting audit conclusions.
3. An internal auditor shall respect the confidentiality of information acquired while performing the audit function.
4. An internal auditor shall only engage in activities that do not conflict with the interests of the organization.
5. An internal auditor shall adhere to conduct that enhances the professional stature of internal auditing.
6. An internal auditor shall exercise due professional care in the performance of all duties and in the fulfillment of all responsibilities.

#### Performance Standards

1. The internal auditor shall prepare a formal audit plan that covers all significant organizational activities over an appropriate cycle of time.
2. The audit plan shall include an evaluation of controls within new systems and significant modifications to existing systems before they become operational.
3. Audit procedures shall provide sufficient and

competent evidential matter to support conclusions regarding the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations.

4. The organization of the audit function and related administrative practice shall provide for the proper supervision of persons performing audits and for the proper review of work performed.

control should extend beyond accounting matters. This broader concept better serves the board of directors and executive management to whom the internal auditor is accountable. Bank Administration Institute believes the systems of control and ongoing operations, as defined herein, provide a preferred perspective for discussing internal auditing within the framework of the auditing discipline taken as a whole.

## Communication Standards

1. The auditor shall prepare a formal report on the scope and results of each audit performed.
2. Each audit report shall contain an opinion on the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations; the degree of compliance with previously evaluated systems of control; or an explanation of why an opinion cannot be expressed. When an adverse opinion is expressed, the report shall contain a statement about the exposures that may exist in the absence of corrective action.
3. The auditor shall communicate audit findings in a timely manner to the managers responsible for corrective action.
4. At least once each year the auditor shall make a summary report of audit activities to the board of directors and executive management. The report shall include an opinion on the overall condition of the organization's controls and operations.

## Concepts of Control

The systems of control exist to assure the achievement of intended results, to promote operating efficiency and to encourage compliance with policies and other established constraints. Although internal auditors have a definite interest in verifying the results of business activity, their primary concern must be the continuing effectiveness of the systems of control that influence business results. The important qualities that must be evaluated are adequacy, effectiveness and efficiency.

In evaluating adequacy, the auditor analyzes systems to determine that they include design features proper to the circumstances and reasonably sufficient to effect control. The evaluation of adequacy begins with the comparison of "what should be" to "what is." Initial audits and audits of proposed procedures or organization structures focus primarily on the adequacy of control.

In evaluating effectiveness, the auditor measures the degree of compliance with control features and the extent to which compliance serves the intended purposes. The question that must be answered is: "Do the controls work?"

In evaluating efficiency, the auditor judges the practicality of controls in terms of their cost relative to their intended benefit. It is not intended that the auditor should evaluate adequacy or effectiveness in absolute terms, nor is it intended that the auditor judge efficiency in absolute terms. An internal auditor's evaluation of efficiency is restricted to the controls themselves and does not extend to the measures of operating performance associated with the functioning of such controls. In judging efficiency, the internal auditor must conclude whether the benefits provided by the controls exceed their cost.

The systems of control and not the audit function:

## COMMENTARY

The following comments are presented in order to promote the acceptance of the "Statement of Principle and Standards for Internal Auditing in the Banking Industry," to provide a context for the application of its concepts and to enhance the understanding of internal auditing. It is intended that the statement and the commentary will serve as a basis for the continuing advancement of the profession's influence and service.

## Internal Auditing as a Discipline

Internal auditing is developing a broader perspective by recognizing that all operations are properly subject to control and within the scope of auditing. The internal auditor's concern for

- Provide reasonable assurance that assets are safeguarded, information (financial and other) is timely and reliable, and errors and irregularities are discovered and promptly corrected.

- Promote operational efficiency.
- Encourage adherence to managerial policies, laws, regulations and sound fiduciary principles.

Those members of management who are responsible for policy implementation are also responsible for the design and the maintenance of the systems of control. Internal auditors are responsible for that management function which independently evaluates the adequacy, effectiveness and efficiency of the systems of control. Internal auditors should make sure that those who rely on their opinions understand that no practical system can guarantee the quality of future performance.

Controls act as a positive force to facilitate successful operations as well as a negative one that restricts activities. Accordingly, the auditor should evaluate control systems in terms of the incentives they provide as well as the sanctions.

Safeguarding assets relates to physical, legal and all other protective means by which the organization assures the full realization of its resources.

All information should be subject to the systems of control. Timely information is that which anticipates a decision need and is available to the persons who will use it when they need it. Reliable information provides a sound basis for decision because of the authenticity of its source, the manner in which it is recorded and the form and content of its presentation.

The systems of control must detect and correct errors and irregularities when preventive controls fail. Sound systems of control contain safeguards that will counteract failures in other controls.

The systems of control should promote operational efficiency. The features of control systems that promote operational efficiency include the processes used to select and train personnel, establish procedures, set performance requirements, measure results and provide incentives.

Managerial policies, laws, regulations and sound fiduciary principles establish bounds within which the organization can conduct its business. The features of the control system that encourage compliance with these requirements include the separation of duties, the employment of persons likely to comply, the establishment of authority limits and the communication of expected conduct.

## Ongoing Operations

Management must evaluate the quality of operations based on information provided by the control systems. Adequate control systems produce sufficient information to reliably appraise operations. To confirm that the control systems are adequate and effective, the internal auditor should independently evaluate the quality of ongoing operations. Only ongoing operations have future significance.

Internal auditors should express their opinion on whether the quality of ongoing operations is satisfactory or unsatisfactory. Satisfactory operations are those which, in the opinion of the auditor, require no extraordinary intervention by executive management or the directors. Conversely, unsatisfactory operations require extraordinary intervention before appropriate remedial action is likely to occur. A qualified opinion may be expressed by citing specific exceptions to satisfactory operations. Auditors may assess the quality of operations more precisely and report on grades of quality, provided the grades are clearly understood by management.

Circumstances may preclude the auditor from forming an opinion on the quality of ongoing operations. This, by itself, is significant because the information provided by the control systems should be adequate for the evaluation of ongoing operations.

## Accountability

Accountability refers to the measures of effective audit performance. The organization standards of this statement define the conditions necessary to hold the auditor accountable for the other standards.

Only the board of directors can protect the auditor's need for independence; consequently, the board should be the final judge of the auditor's performance. The fact that the process of measurement may be done through an audit committee does not alter the auditor's ultimate accountability to the board.

Both the auditor and executive management have received a delegation of authority from the board: management to design and maintain systems of control; the auditor to evaluate these systems of control. Because the evaluation process exists to serve the design and maintenance responsibility, the auditor must also be account-

able to executive management. This accountability, however, does not create the usual corollary right of the executive to directly apply sanctions or to otherwise restrict the auditor's functional independence. Such action, if necessary, must be decided by the board.

The auditor should be mindful that the audit function serves many users. The auditor has an obligation, if not accountability, to those users. The auditor's personal relationship with others should be characterized by integrity, open communication and mutual respect. User satisfaction should be an important consideration in the board's evaluation of audit performance.

Independence is a matter of personal quality rather than of rules. The auditor's relationships, as indicated by the plan of organization and by the way in which the work is conducted, must always be such that a presumption of independence logically follows in the mind of the observer.

## Organization Standards

A banking organization can best evidence its support and commitment to the professional standards of internal auditing by formally adopting these standards.

The organization standards are prerequisites to the personal, performance and communication standards. They simply state that an internal auditor cannot be accountable for adherence to the other standards without the necessary resources and support of the organization.

Many banks cannot afford the services of a competent and independent internal auditor. It should be clearly understood that those banks are not in compliance with these standards. Their directors and executive management, therefore, bear the burden of providing additional supervision to assure the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations.

The organization shall provide and maintain an environment within which the internal auditor has the freedom to act. Persons whose duties and responsibilities are subject to audit cannot have the authority to regulate the scope of audit work nor the procedures considered necessary by the auditors. The auditor's responsibility to independently evaluate the systems of control must carry with it the authority to set the scope and choose the means of examination.

Budgeting should be based on a complete plan of audit that demonstrates fulfillment of the organization's audit needs and adherence to the standards of internal auditing. In committing resources to the internal audit function, the organization should expect the auditor to properly support requested allocations through the established budget process.

The audit process is not complete until the auditor is satisfied that audit findings have received appropriate attention. By requiring management to respond formally to audit findings, the organization contributes to the effectiveness of the audit function and increases the likelihood that the findings will receive appropriate attention.

The organization should measure the performance of its internal audit function in relation to the timeliness, efficiency and the quality of its work. Timeliness is indicated by scheduling the work in recognition of risk assessments and by the prompt issuance of reports. Efficiency is indicated by completing the work within the time budgeted. An efficient internal audit program also minimizes the time required by examiners and public accountants without affecting adequate coverage. Formal work programs, workpapers and the form and content of reports evidence the quality of an audit function. The organization should consider using the opinions formed by bank examiners, certified public accountants and other professional auditors to assist in this performance evaluation. Smaller banks may find the services offered by their correspondents include such evaluations.

## Personal Standards

Personal standards relate to the qualifications of auditors, the quality of audit practice and the rules of professional conduct. They concern all persons who apply audit procedures under a delegation of authority from the board to support conclusions regarding the systems of control. Personal standards are prerequisites to performance and communication standards.

All persons engaged in the practice of internal auditing shall have the technical training and proficiency necessary to conduct their audit duties in accordance with these standards. Technical training and proficiency are separate requirements. Technical training relates to education; proficiency relates to the skill and judgment acquired through experience.



The qualified internal auditor will have successfully completed a course of study and training in disciplines having audit significance and will understand their application to banking. These disciplines include the principles of accounting, auditing, economics, finance, operations analysis, management, statistics, commercial law and computer science.

Experience is gained by working under the close supervision and review of an experienced professional. This relationship should make the job itself a vehicle for seasoning and refining the technical training acquired through formal education. On-the-job training should be carefully planned and organized. Those responsible for managing the audit function should define the elements of knowledge and judgment that may be gained from experience and establish a way to measure the resulting proficiency.

Proficiency is demonstrated by the proper exercise of professional judgment. It is difficult for users of professional services to accurately assess proficiency. Therefore, recognized professions, including internal auditing, provide certification programs for their practitioners. Each person engaged in the internal audit function can demonstrate proficiency by earning a professional designation such as chartered bank auditor, certified internal auditor or certified public accountant. The last two designations, however, require successful banking or related experience to demonstrate a practical knowledge of the industry.

The modern business environment demands that an internal auditor maintain proficiency by active participation in programs of continuing education and professional association.

There is no concept more important to internal auditing than independence. The essence of independence is intellectual honesty informing conclusions and expressing opinions. Conclusions must be reached fairly without bias or the propensity to prejudice circumstances. Opinions must be expressed forthrightly despite the conflicts that may arise. Although the appearance of independence relies on a plan of organization that grants the auditor freedom from conflicting accountabilities, the actual attainment of independence depends solely on the individual. The concept of independence is most fundamental to the definition and practice of auditing.

Independence is not isolation. Auditors should not allow their need for independence to inhibit the contacts and rapport necessary for a fully effective audit function.

Banking organizations properly require all employees to honor the confidentiality of financial and other information obtained during their employment. This requirement is all the more important for internal auditors because of the nature and scope of their work. Confidentiality also applies to the judicious use of information within the organization.

An internal auditor should not accept employment or participate in activities that compete or otherwise oppose the lawful objectives of the organization. Loyalty reflects integrity and credibility. Relationships which may, even by implication, raise doubt concerning the auditor's loyalty to the bank therefore must be avoided.

All members of a profession owe allegiance to their colleagues. The reputation of all depends to some degree on the conduct of each. Internal auditors develop professional recognition by supporting and participating in associations organized to serve their common needs. Each internal auditor is also obligated to maintain proficiency and awareness through self-education.

Due professional care imposes an ethical obligation on all auditors to demonstrate competency. Due care acts as a safeguard against negligence and oversight. Due professional care applies to the administrative practices that bear on the quality of audit results as well as to the use of audit procedures that provide sufficient competent evidence.

Due professional care is a subjective standard based on reasonableness. The duty of due professional care requires the auditor to know the extent of reliance that others within the organization place on audit results. When such reliance is unrealistic or misunderstood, the auditor should resolve the misunderstanding and temper unrealistic expectations.

The organization should require the presentation of audit findings in a manner that convinces management that the auditor exercised due professional care.

## Performance Standards

The audit plan should be written and presented in a form that is suitable for critical review by audit committees, certified public accountants, regulatory examiners and others who must evaluate the adequacy of audit coverage.

An audit plan is based on a catalog of examinations that includes all significant activities of the organization classified by logical

units for work scheduling. For example, demand deposit bookkeeping functions may be classified as three separate audits: overdraft control practices, confirmation of balances and bookkeeping operations.

The frequency of audit should be determined by reference to factors affecting risk, management information, customer satisfaction and the need to create an awareness of audit presence. Risk assessment involves audit judgment regarding how often and to what extent the systems of control must be evaluated.

In mature audit operations, the problem of balancing audit objectives with audit resources has usually been solved. Risk assessment in the context of audit planning does not normally change in the near range. The audit plan for each cycle does not prescribe a detailed listing of tests and procedures to be applied. These tactical steps are to be found in the work program.

The audit plan, which usually represents work contemplated for the current year, should present the information necessary to schedule and assign the work. It should cover resources requirements, administrative goals and objectives and the estimated costs of audit. Resource plans identify the number of persons needed, schedule their time (including such non-audit time as administration, vacation, lost days, staff training) and specify the level of ability. Administrative goals and objectives should reflect the audit implications of conditions that influence the organization. Audit costs should be identified in sufficient detail to encourage the audit manager to justify their cost and impact on the organization.

While cost justifying the audit plan, the auditor should recognize that the organization's cost of control includes its cost of auditing. In certain areas, efficiencies may best be achieved by strengthening the control systems as an alternative to audit coverage.

The audit plan shall include an evaluation of the adequacy of controls within new systems and significant modifications to existing systems before they become operational. This evaluation should include the controls designed into the conversion plan. Significant modifications are those that affect controls to an extent that audit concern is created regarding the organization's resulting exposure to loss.

The second performance standard concerns the timing of audit but not its scope. Identifying significant changes and establishing audit procedures is a matter of individual audit judgment. Modern complex systems are expensive to

develop and maintain. Building adequate controls within the original design is usually less costly than adding them after the system is operational. The cost of evaluation, however, is usually no greater before implementation than after.

The reliability of audit results depends on the character of supporting evidence. Audit procedures should be selected and applied in a way that assures such evidence is sufficient and competent.

The term "sufficient" as used here means that enough evidence is assembled to assure that audit conclusions are well founded. The internal auditor's determination of what constitutes enough evidence is a matter of professional judgment relative to the controls and operations under evaluation. Frequently, sufficiency can be demonstrated by the application of statistical sampling techniques.

The term "competent" means relevant and valid. Competent evidence has the requisite ability to convince. Both the substance and the interrelationship of evidence demonstrate competence. Whereas sufficient is a quantitative concept, competent is a qualitative one.

Competency for audit purposes depends on the procedures used to obtain evidence. Direct knowledge, such as obtained by observation or inspection, is more reliable than indirect knowledge, such as obtained by confirmation and inquiry. Obtaining the most competent evidence, however, is not always feasible. Selecting and applying those procedures that collectively produce the most competent evidence under the circumstances demonstrates audits proficiency.

Audit work should be organized so that the objectives at each level of detail are clearly defined. Each phase of the work as well as the contribution of each person should be viewed by a superior. Audit management should review the audit programs, questionnaires and other planning features for completeness, applicability and efficiency. The reviewer should be satisfied that those who perform field work understand the systems under examination and the audit procedures that have been selected for application.

The auditor in charge of each assignment should perform a detailed review of the work as it is completed. No work should be accepted unless it complies with the standard of evidence. Audit management should conduct a comprehensive final review of the workpapers to determine that proper procedures were applied, sufficient evidence was assembled and all excep-

tions were properly evaluated in terms of their control significance. Audit management should also make interim field reviews.

Reviews must be documented. All auditors should appreciate the importance of the review process and perform their work in a manner that facilitates review. Review serves as an educational process as well as a control. Directors of banks employing only one auditor should supervise the auditor's work in a manner that provides a check on audit quality.

## Communication Standards

The auditor has a responsibility to report the results of all audit work performed. Some auditors prefer to report only significant exceptions; however, this practice reinforces a negative view of the audit function. The auditor's responsibility to evaluate control systems and ongoing operations carries with it an obligation to report the results of that evaluation. Without a report, management does not have positive assurance that auditing is meeting its commitments. Consequently, management can only assume that adequate coverage is maintained and that the systems of control are functioning adequately, effectively and efficiently. By implication, audit reporting only on an exception basis extends the auditor's responsibility beyond what the actual work can support and causes misunderstanding.

Requiring auditors to express an opinion on the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations enables the board of directors, management and other interested parties to better judge the reliability of the control systems and ongoing operations. This service is a natural and logical part of the internal auditor's accountability.

Expressing an opinion imposes a serious obligation on the auditor. The requirement of due professional care extends to both the opinion and the commentary supporting it. Clear identification of the systems of control audited is the key to a meaningful opinion.

Each auditor should develop standard language for rendering an opinion. Standardization of language minimizes misunderstanding and promotes recognition of circumstances that require responsive action.

It is suggested that auditors develop their opinion statement along the following lines:

“In our opinion (the audit subject's) operating and accounting procedures include those practices usually necessary to provide adequate and efficient control. Also in our opinion, the degree of compliance with such procedures provided effective control during the (period of audit). We found the quality of ongoing operations satisfactory.”

This opinion assumes the auditor has reviewed the systems of control before they became operational and is satisfied that they include design features proper to the circumstances and reasonably sufficient to effect control. The second sentence of the opinion addresses the degree of compliance with control features previously found adequate and efficient. Audits of operations that are subject to a common control system such as a typical branch bank audit need not include a review of the system each time a unit audit is performed. The auditor, however, should be satisfied that all modifications to the existing system that significantly affect control have been evaluated.

Auditors occasionally form adverse conclusions concerning the adequacy, effectiveness or efficiency of the systems of control or the quality of ongoing operations. In these cases, they should qualify their opinion and identify exposures that may exist in the absence of corrective action. Risk measures the degree to which exposures are uncontrolled. The applicable equation is: Exposure minus control equals risk. A calculated risk is taken only when the exposure is fully identified and the implications of the lack of control are understood. To make an adverse opinion clear and meaningful, therefore, the auditor must identify relevant exposures and explain their significance.

Every audit report should identify the area audited and disclose all matters the auditor believes require responsive action by the recipient. Auditors should clearly distinguish between those matters to which they take exception and those that are reported for other reasons. The degree of detail reported is largely a matter of judgment, influenced greatly by the preferences of management. Some managements prefer to have all audit findings reported no matter how minor. Others prefer only a general description of significant findings. Auditors must bear in mind that their ultimate accountability demands that findings of major significance be brought to the attention of executive management and the board of directors.

The standards do not require the auditor to recommend corrective action. In practice, however, auditors find that many managements expect suggestions for corrective action, particularly when the technical aspects of controls are involved. By suggesting corrective action, the auditor demonstrates a positive approach to the organization's problems. In making suggestions, auditors should recognize that their recommendations may not be the only means of achieving the control purpose intended. The focus of concern should be the control purpose and not the particular means selected from a range of acceptable choices.

A draft of each audit report should be made available to the manager of those operations under examination. Findings should be discussed with the manager before final issuance of the report. Any revisions should be similarly reviewed. The final report must clearly present audit findings and avoid language that may imply a meaning inconsistent with the supporting evidence. A review and a discussion of the draft assure this result.

Auditors must establish the facts of their findings but do not have to obtain complete management acceptance of their comments before issuing a report. Auditors should be prepared for occasional conflict and disagreement.

The ease with which auditors can retrieve information, support fact and amplify findings validates the adequacy and the quality of audit evidence. The extent to which auditors gain acceptance of their comments ultimately measures the effectiveness of internal auditing's contribution to the organization.

The timeliness with which audit findings are reported is very important and often critical for effective response. When timeliness is critical, the auditor should communicate findings promptly and not await the preparation of a formal report. Findings should be communicated to the manager whose operation is directly affected.

The extent and frequency of audit reports required by the board of directors varies with the organization. At least annually, however, the auditor shall formally report to the board of directors and executive management. The board of directors and executive management are entitled to a report that measures audit performance against plan and provides information normally required to establish accountability. The auditor should use this opportunity to pro-

mote an understanding of the audit function and how it serves the organization.

In the summary report, the auditor should express an opinion on the overall condition of the organization's controls and ongoing operations. The report should present all known control problems of significance as well as an evaluation of corrective action taken. Although the report is formal, it should be presented personally to ensure proper interpretation and to provide the benefit that flows from the exchange of information and concerns.

## Fraud and the Auditor's Responsibility

The auditor is charged with understanding the purposes of the business, the control practices usually necessary to achieve them, and the type of evidence that indicates they will continue to be achieved. The following questions are prerequisite to evaluating the systems of control: What is the purpose of the system? How is it controlled? What can go wrong?

Audit proficiency includes the ability to evaluate fraud exposures. Sufficient information is available in the literature on auditing concerning how frauds may be committed in banking. The auditor should be familiar with that literature.

The systems of control and not the internal audit function provide the primary assurance against fraud. Internal auditors, however, must evaluate the capability of the systems to achieve that end. When in doubt, the auditor should consider applying additional procedures to determine if fraud has actually occurred.

In fixing the internal auditor's responsibility for detecting fraud, it should be recognized that the internal auditor cannot be responsible for detecting irregular transactions for which there is no record, e.g., an unrecorded receipt of cash from a source for which there is no evidence of accountability; an isolated transaction that does not recur, e.g., a single fraudulent loan; or irregularities that are well concealed by collusion. However, in the usual course of the audit cycle, the internal auditor should detect irregularities that significantly affect the financial statements, repeatedly follow a suspicious pattern of concurrence, or those that can be detected by a reasonable audit sampling. Internal auditors must also accept responsibility for those irregularities that result from their failure to report known weaknesses in the systems of control.

In judging the preventive capacity of the control systems and the internal auditor's responsibility, the principle of relative risk should not be ignored, namely, costs must be balanced against intended benefit.

## CONCLUSION

Professional internal auditors can contribute a wealth of information to their organizations over and above the assurance they provide by evaluating the quality of control systems and ongoing operations. The word, "audit," comes from the Latin word, *audire*, meaning to hear. Internal auditors should be good listeners and observers. They should demonstrate an in-depth understanding of the strengths and weaknesses of the organization, the accomplishments and current problems of its departments, the quality of its services, the pride and concerns of its people and the efficiencies and diseconomies of its operations. In turn, executives and directors should listen to professional internal auditors and capitalize on their observations.

## EXAMPLES OF UNSAFE AND UNSOUND LIMITATION-OF-LIABILITY PROVISIONS

*The following information was contained in appendix A of the February 9, 2006, interagency advisory.*

Presented below are some of the types of limitation-of-liability provisions (with an illustrative example of each type) that the agencies observed in financial institutions' external audit engagement letters. The inclusion in external audit engagement letters or agreements related to audits of any of the illustrative provisions (which do not represent an all-inclusive list) or any other language that would produce similar effects is considered an unsafe and unsound practice.

### 1. "Release from Liability for Auditor Negligence" Provision

In this type of provision, the financial institution agrees *not* to hold the audit firm liable for

*any damages, except to the extent determined to have resulted from willful misconduct or fraudulent behavior by the audit firm.*

*Example: In no event shall [the audit firm] be liable to the Financial Institution, whether a claim be in tort, contract or otherwise, for any consequential, indirect, lost profit, or similar damages relating to [the audit firm's] services provided under this engagement letter, except to the extent finally determined to have resulted from the willful misconduct or fraudulent behavior of [the audit firm] relating to such services.*

### 2. "No Damages" Provision

In this type of provision, the financial institution agrees that *in no event* will the external audit firm's liability include responsibility for any compensatory (incidental or consequential) damages claimed by the financial institution.

*Example: In no event will [the audit firm's] liability under the terms of this Agreement include responsibility for any claimed incidental or consequential damages.*

### 3. "Limitation of Period to File Claim" Provision

In this type of provision, the financial institution agrees that *no* claim will be asserted after a fixed period of time that is shorter than the applicable statute of limitations, effectively agreeing to limit the financial institution's rights in filing a claim.

*Example: It is agreed by the Financial Institution and [the audit firm] or any successors in interest that no claim arising out of services rendered pursuant to this agreement by, or on behalf of, the Financial Institution shall be asserted more than two years after the date of the last audit report issued by [the audit firm].*

### 4. "Losses Occurring During Periods Audited" Provision

In this type of provision, the financial institu-

tion agrees that the external audit firm's liability will be limited to any losses occurring during periods covered by the external audit, and will *not* include any losses occurring in later periods for which the external audit firm is not engaged. This provision may not only preclude the collection of consequential damages for harm in later years, but could preclude any recovery at all. It appears that no claim of liability could be brought against the external audit firm until the external audit report is actually delivered. Under such a clause, any claim for liability thereafter might be precluded because the losses did not occur during the period covered by the external audit. In other words, it might limit the external audit firm's liability to a period before there could be any liability. Read more broadly, the external audit firm might be liable for losses that arise in subsequent years only if the firm continues to be engaged to audit the client's financial statements in those years.

*Example: In the event the Financial Institution is dissatisfied with [the audit firm's] services, it is understood that [the audit firm's] liability, if any, arising from this engagement will be limited to any losses occurring during the periods covered by [the audit firm's] audit, and shall not include any losses occurring in later periods for which [the audit firm] is not engaged as auditors.*

#### 5. “No Assignment or Transfer” Provision

In this type of provision, the financial institution agrees that it will not assign or transfer any claim against the external audit firm to another party. This provision could limit the ability of another party to pursue a claim against the external auditor in a sale or merger of the financial institution, in a sale of certain assets or a line of business of the financial institution, or in a supervisory merger or receivership of the financial institution. This provision may also prevent the financial institution from subrogating a claim against its external auditor to the financial institution's insurer under its directors' and officers' liability or other insurance coverage.

*Example: The Financial Institution agrees that it will not, directly or indirectly, agree to assign or transfer any claim against [the audit firm] arising out of this engagement to anyone.*

#### 6. “Knowing Misrepresentations by Management” Provision

In this type of provision, the financial institution releases and indemnifies the external audit firm from any claims, liabilities, and costs attributable to any knowing misrepresentation by management.

*Example: Because of the importance of oral and written management representations to an effective audit, the Financial Institution releases and indemnifies [the audit firm] and its personnel from any and all claims, liabilities, costs, and expenses attributable to any knowing misrepresentation by management.*

#### 7. “Indemnification for Management Negligence” Provision

In this type of provision, the financial institution agrees to protect the external auditor from third-party claims arising from the external audit firm's failure to discover negligent conduct by management. It would also reinforce the defense of contributory negligence in cases in which the financial institution brings an action against its external auditor. In either case, the contractual defense would insulate the external audit firm from claims for damages even if the reason the external auditor failed to discover the negligent conduct was a failure to conduct the external audit in accordance with generally accepted auditing standards or other applicable professional standards.

*Example: The Financial Institution shall indemnify, hold harmless and defend [the audit firm] and its authorized agents, partners and employees from and against any and all claims, damages, demands, actions, costs and charges arising out of, or by reason of, the Financial Institution's negligent acts or failure to act hereunder.*

#### 8. “Damages Not to Exceed Fees Paid” Provision

In this type of provision, the financial institution agrees to limit the external auditor's liability to the amount of audit fees the financial institution paid the external auditor, regardless of the extent of damages. This may result in a

substantial unrecoverable loss or cost to the financial institution.

*Example: [The audit firm] shall not be liable for any claim for damages arising out of or in connection with any services provided herein to the Financial Institution in an amount greater than the amount of fees actually paid to [the audit firm] with respect to the services directly relating to and forming the basis of such claim.<sup>1</sup>*

## FREQUENTLY ASKED QUESTIONS ON THE APPLICATION OF THE SEC'S AUDITOR-INDEPENDENCE RULES

*The following information is contained in appendix B of the February 9, 2006, interagency advisory.*

### *Question<sup>2</sup>*

Inquiry was made as to whether an accountant who certifies financial statements included in a registration statement or annual report filed with the commission under the Securities Act or the Exchange Act would be considered independent if he had entered into an indemnity agreement with the registrant. In the particular illustration cited, the board of directors of the registrant formally approved the filing of a registration statement with the commission and agreed to indemnify and save harmless each and every accountant who certified any part of such statement "from any and all losses, claims, damages or liabilities arising out of such act or acts to which they or any of them may become subject under the Securities Act, as amended, or at 'common law,' other than for their willful misstatements or omissions."

### *Answer*

When an accountant and his client, directly or through an affiliate, have entered into an agree-

1. The agencies also observed a similar provision that limited damages to a predetermined amount not related to fees paid.

2. The subtitles in this section have been revised for this manual.

ment of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other cases it may result in a failure to appraise with professional acumen the information disclosed by the examination. *Consequently, the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation.*

### *Question*

Has there been any change in the commission's long-standing view (Financial Reporting Policies—Section 600—602.02.f.i., "Indemnification by Client") that when an accountant enters into an indemnity agreement with the registrant, his or her independence would come into question?

### *Answer*

No. When an accountant and his or her client, directly or through an affiliate, enter into an agreement of indemnity that seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, *the accountant is not independent.* Further, including in engagement letters a clause that a registrant would release, indemnify or hold harmless from any liability and costs resulting from *knowing misrepresentations by management would also impair the firm's independence.<sup>3</sup>*

3. U.S. Securities and Exchange Commission; Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence—Frequently Asked Questions; Other Matters, Question 4 (issued December 13, 2004).

# Cash Accounts: Financial Recordkeeping and Reporting Regulations— Examination Procedures

Section A.2000.1

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The material in this section has been incorporated into the *Bank Secrecy Act Examination Manual*.



# Loan Portfolio Management: Comprehensive Mortgage Banking Examination Procedures

Effective date April 2012

## Section A.2040.3

The following comprehensive examination procedures address the examination and supervisory concerns discussed in the February 25, 2003, Interagency Advisory on Mortgage Banking and in SR-03-4. The procedures incorporate and consolidate that supervisory and examination guidance, examination modules, and the Federal Reserve's mortgage banking inspection procedures found in section 3070.0 of the *Bank Holding Company Supervision Manual*. See SR-97-21, "Risk Management and Capital Adequacy of Exposures Arising from Secondary Market Credit Activities." See this manual's section 2070.1 on the "Allowance for Loan and Lease Losses," with particular reference to the subsections on "Estimated Credit Losses in Credit Related Accounts" and the "Interagency Policy Statement on the Allowance for Loan and Lease Losses." In addition, see SR-05-10, "Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans," and this manual's sections 2040.1, 2040.2, and 2040.3. Collectively, this guidance focuses on determining the level of risk associated with banks that originate and sell loans, and the appropriate risk-management practices that may be used to mitigate those risks. The following comprehensive procedures are organized according to the typical structure of a banking organization and its primary activities.

### PRELIMINARY REVIEW AND ASSESSMENT

1. Perform the following preliminary examination review procedures.
  - a. Review the following reports and documentation:
    - internal auditors' reports
    - the most recent external audit report and management letter, and management's response to criticisms and recommendations
    - government-sponsored agencies' reports and significant private investors' reports, if available
    - internal memoranda and management reports on the mortgage banking unit prepared since the previous examination
  - b. Briefly review information about the mort-

gage banking entity's financial performance to gain a basic understanding of its assets, liabilities, and profitability.

2. Review the types of products offered and markets targeted by the bank's mortgage banking entity.
  - a. Ascertain whether the entity has an over-reliance on one product type or if it relies on a few large geographic concentrations.
  - b. Determine if the entity has made any material changes in its types of products, underwriting criteria, production and servicing volumes, and market focus.
3. Review the findings of the external and internal auditors, the quality-control unit, and any other reviews, including any reviews conducted by independent investors, other governmental agencies, and quasi-governmental investor or guarantor agencies (all those audits and reviews conducted since the previous examination). Note the level of compliance with various internal controls and quality controls as well as compliance with established limits and controls on lending, securitization, and hedging activities.
  - a. On the basis of this examination review, make a preliminary determination about the current volume and level of risk (that is, credit risk (borrower and counterparty risk), market risk (pipeline, interest-rate, trading, price, prepayment, hedging, and foreign-exchange risks), liquidity—funding, operational, and legal risk (compliance, strategic, and contingency risks), and reputational risk.
  - b. Assess the adequacy of risk management and the level and direction of composite risk for significant activities.
  - c. Determine the scope and focus of the examination of mortgage banking operations, transactions, and activities.
4. Develop a preliminary assessment of the financial impact of the mortgage banking entity's operations, transactions, activities, and most significant risks on the bank's current financial condition, liquidity, earnings, and capital.

## BOARD AND SENIOR MANAGEMENT OVERSIGHT

### Board of Directors

1. Review the biographies of the members of the board of directors and review the board's and board committees' meeting minutes. Determine whether the directors have the necessary education and experience to fulfill their fiduciary responsibilities.
2. Assemble and review several of the most recent informational packages that were provided to the directors before their scheduled meetings. Find out if the directors receive sufficient detailed information to make informed judgments about the financial condition, internal controls, and risk-management controls and procedures of the mortgage banking entity.
3. Ascertain whether the board of directors is fulfilling its fiduciary responsibilities in business planning, approving operating policies, hiring competent management, and overseeing business performance.

### Management

4. With respect to senior management, determine—
  - a. if detailed policies and procedures are in place to monitor and control mortgage banking activities involving loan production (including origination, underwriting, closing, and wholesale and correspondent lending activities), pipeline (unclosed loans) and warehouse (closed loans) administration, secondary-market (selling, recourse, and servicing) transactions, servicing operations, and management (including hedging) of mortgage-servicing assets; and
  - b. if the reports and limits focus on key risks, profitability, and proper accounting practices.
5. Review the biographies of executive management.
  - a. Determine if the level of experience, education, technical knowledge, leadership skills, expertise, and administrative capabilities of management is sufficient for overseeing the mortgage banking operations.
  - b. Determine whether senior management's

- salaries are commensurate with the biographical information provided.
  - c. Determine if management's depth and succession plans are adequate.
6. Determine if a separate board committee for mortgage banking activities exists. If so, review the committee's minutes for significant approvals for transactions, activities, and other authorized actions.
7. Determine if the directors, management, and auditors are adequately evaluating, monitoring, and maintaining internal controls over the valuation and modeling processes, the most significant risks and their respective hedging activities, management information systems, and the internal audit function.
8. Review the mortgage banking strategic plan and planning process. Determine if the goals are reasonable, attainable, and complement the bank's overall business plan.
9. Evaluate the documentation of the planning process, including the most recent operating budget, the business plan, and the related performance measurement system reports. Determine whether the objectives, goals, and growth targets are reasonable and properly aligned with achievable performance levels.
10. Determine if adequate disaster-recovery and contingency plans exist to address the mortgage banking entity's primary risks.

### Policies and Procedures

11. Review and evaluate the quality and effectiveness of the bank's mortgage banking policies and procedures within each of the functional internal control areas. Also evaluate the extent to which compliance is achieved, monitored, and reported in the following areas, among others:
  - a. defined permissible mortgage banking activities
  - b. the responsibilities designated to individual officers and employees
  - c. lending limits
  - d. segregation of duties
12. Determine if the bank's policies, procedures, and strategies within other functional areas consider mortgage banking activities. Consult with those examiners reviewing the other functional areas and coordinate your findings with them.

13. Investigate why any identified policy and procedure deficiencies exist. Discuss with management any recommendations for correcting deficiencies. Ascertain whether—
  - a. management overlooked the needed policies and procedures,
  - b. management is unfamiliar with prudent mortgage banking guidelines and procedures, or
  - c. management is unwilling to create or enhance policies and procedures.
14. If there is lack of compliance with policies and procedures, determine whether the reasons are the result of a—
  - a. lack of awareness of the existence of the policies,
  - b. disregard for the established policies,

- c. misunderstanding of the intent of policy guidelines, or
  - d. a poor internal process for communicating any revisions to the policies and procedures.
15. Determine if management commits to and supports proper controls and monitoring to ensure that policy guidelines will be adhered to in the future.

### INTERNAL AUDIT OR INDEPENDENT REVIEW, EXTERNAL AUDIT, INTERNAL CONTROLS, AND QUALITY CONTROL

1. Review the findings of the internal and external audits, quality-control reports, and investor audits to find out if the internal controls are functioning effectively.

#### Internal Audit or Independent Review

2. Determine whether a separate and independent internal audit function exists and if each internal auditor is independent.
3. Review and assess the qualifications of the internal audit manager and the internal audit staff for mortgage banking, including their accounting and auditing expertise. When making the assessment, consider the department's size; the complexity of its operations and activities; the quality of ongoing staff-training programs; and the staff's experience, education, and certification levels in relation to the volume of existing risk exposures.
4. Determine if, since the previous examination—
  - a. the scope and frequency of the most recent audits and independent reviews were adequate to identify policy, reporting, and internal control deficiencies and all areas of high or significant risk; and
  - b. the audit schedule or plan and coverage included a review of the underwriting practices and other high-risk areas of the mortgage unit or entity.
5. Review all internal audits, internal audit follow-up reports, and management responses to the auditors' findings that were issued since the previous examination.
  - a. Select a significant sample of the work-

papers from the audits for the bank's high-risk mortgage banking operations and activities. Conduct an intensive review of those phases of the internal audits.

- b. Ascertain whether all significant issues and exceptions were brought forward to the final audit report, that the report was promptly presented to the board of directors or its designated audit committee, and whether the cited significant problems or control weaknesses received appropriate and prompt management attention and correction.
  - c. Evaluate the system internal audit uses to follow up on unresolved issues or problems.
6. Assess the adequacy of the reviews of mortgage-servicing assets that were conducted by internal audit or quality control or by independent reviews.
  7. Determine if the internal audit or quality-control programs cover compliance with state and federal laws, generally accepted accounting principles, and investor requirements (including minimum capital requirements).
    - a. Interview those responsible for monitoring compliance and find out the nature of outstanding problems and issues.
    - b. Assess the adequacy and extent of the correction of the problems and issues.
  8. Review any high-risk transactions or activities conducted since the previous examination that were not adequately addressed during the internal audit or independent review.
  9. Investigate any remaining identified internal audit or independent-review deficiencies that have occurred since the previous examination.

#### External Audit

10. Review, follow, and apply the examination guidance on the review of external auditing programs that is found in the Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations. In addition, follow the examination guidance in part IV of the Policy Statement on the External Audit Function, adopted May 17, 2003. (For both policies, see section 1010.1.)

11. Review the engagement letters for the external audits performed since the previous examination.
  - a. Determine the extent of the external auditor's scope and responsibilities and the extent to which the external auditors relied on the findings of the internal auditors.
  - b. Verify that the external auditor's report included an unqualified opinion on the bank's (and also the mortgage banking entity's) financial condition and on the results of the bank's (or mortgage banking entity's) operations. If a qualified opinion was issued, review and investigate any cited internal control or other significant weaknesses or risks.
  - c. Review the notes to the financial statements and determine if all required disclosures were made.
12. Review and determine the adequacy of the workpapers supporting the external audits performed since the previous examination.
  - a. On the basis of the nature and extent of the audit work performed, management's representations and responses to management letters, and the results of the audit, determine if there were any audit weaknesses or any cited unusual items, practices, or weaknesses in internal control and other areas of concern.
  - b. Investigate the nature and status of any of the uncorrected items (and the respective management responses) with the external auditor and the audit committee. In particular, review and discuss any items that were considered to be material or high risk in relation to the mortgage banking entity's size and complexity of operations.
  - c. Determine whether the scope of any phase of the external audits conducted since the previous examination needs additional examination scrutiny or needs to be expanded to address unresolved significant concerns, problems, or risks (in particular, for the examination and other concerns listed in section 2040.1).
13. Find out and investigate the reasons for any recent or frequent changes in the external auditors who perform audits of the bank, including the mortgage banking entity. If significant, discuss those reasons with the audit committee and the lead or managing external auditor.

## Internal Controls

14. Determine if management establishes and implements an effective, high-quality internal control program that identifies, controls, and minimizes significant risks. Verify that the internal control program includes internal and external audits, accounting controls, loan-quality controls, and internal control procedures for all activities of the mortgage banking entity's operations; insurance coverage; and fraud detection. Determine if the program is reviewed annually.
15. Determine and evaluate the nature of the internal control environment and how risk parameters (limits) are communicated to employees within the mortgage banking entity.
16. Evaluate the internal control process for granting exceptions to the bank's policies and procedures.
17. Find out if internal control procedures exist to—
  - a. control legal risk (guarding against material insurance claims, class-action lawsuits, etc.);
  - b. detect fraud, investigate suspected fraudulent activity, and ensure the filing of criminal referrals; and
  - c. ensure the issuance of appropriate management reports.

## Quality Control

Quality control implements a system of internal controls that provides management with an opportunity to examine and, if necessary, adjust its policies and procedures. It comprises a system of internal controls that sets standards, measures performance, and determines compliance with applicable legal, federal-agency, and investor requirements. Quality control also provides for the timely correction of deficiencies when they are identified.

18. Ascertain whether the bank's mortgage banking entity has a quality-control unit that is independent of the production function.
  - a. Determine if the quality-control unit is organized to (1) promote efficiency, (2) prevent costly errors that could drain profits, (3) ensure that standardized policies and procedures are known and

- adhered to, (4) verify that policies and procedures are revised on a timely basis, (5) ensure that employees are held accountable for failures, and (6) ensure that procedures exist to facilitate the expansion of the internal audit function when needed.
- b. Ascertain whether quality control evaluates the quality of loans originated or purchased (this evaluation is usually required by investors). Verify that the quality-control program ensures that all loans are originated, processed, underwritten, closed, and serviced according to the bank's internal lending policy and investors' standards and criteria.
19. Determine if the quality-control program meets varying investor guidelines.
    - a. Verify that the quality-control program covers both retail and wholesale loan production.
    - b. If certain investors require 10 percent of closed loans to be reviewed, find out if the reviews are conducted within 90 days of closing.
  20. Find out if any of the quality-control-review activities are outsourced and if they are outsourced in compliance with the bank's quality-control standards.
  21. Review a sample of reports the quality-control unit has issued since the previous examination. Determine if the review coverage was adequate and if the unit's findings were correct and appropriate.
  22. Determine if the quality-control findings are clearly documented and promptly presented to the board of directors and senior management. Determine whether the directors and senior management follow up on the findings and oversee their timely resolution.
  23. If any of the quality-control loan reviews disclosed significant risk, deficiencies, and areas of concern that have arisen since the previous examination, determine (1) if management's responses were reasonable and appropriate and (2) if the problems cited were promptly corrected or resolved.
  24. Determine if any of the quality-control findings or areas of concern were addressed by the internal or external auditors. Review the auditors' workpapers pertaining to any reported significant and persistent problems or areas of concern.

## ACCOUNTING

### Held for Sale

1. Determine if, at the time a loan is transferred to the held-for-sale account, there was (1) any reduction recorded for the loan's cost in excess of its fair value, resulting in a new cost basis, and (2) a corresponding reduction in the allowance for loan and lease losses (ALLL). If a reduction was not recorded for a loan's cost in excess of its fair value in the ALLL, determine whether there was an additional loan-loss provision recorded to maintain the ALLL at an adequate level.
2. Determine if assets held for sale are segregated from portfolio loans, revalued at each subsequent reporting date until sold, and then reported at the lower of cost or fair value, as required by Statement of Financial Accounting Standards No. 115 (FAS 115), as amended by Statement of Financial Accounting Standards No. 140 (FAS 140).
3. Determine if loans and other assets that are transferred to the held-for-sale account are being revalued at each subsequent reporting date until sold and whether they are reported at the lower of cost or fair value.
4. Determine if warehoused assets held for sale are segregated from portfolio mortgages. Determine if assets held for sale are recorded on the books at the lower of cost or fair value in accordance with FAS 115 (as amended by FAS 140). If the cost of the assets exceeds fair value, determine if the excess is accounted for as a valuation allowance and that there is no ALLL for assets held for sale.
  - a. Verify that assets transferred from the warehouse to the permanent portfolio are being revalued at each subsequent reporting date until sold. Verify that the asset transfers are reported at the lower of cost or fair value.
  - b. Determine if warehouse loans are accurately recorded in the general ledger and in the bank's financial statements and reports of condition.
5. Determine if any declines in loan value (including those attributable to changes in credit quality) and loan recoveries on such declines in value occur after the loans are transferred to the held-for-sale account. Find

out if declines or recoveries are accounted for as increases or decreases in a valuation allowance for loans held for sale and not as adjustments to the ALLL.

- a. Confirm that changes in the valuation allowance are being reported in current earnings and that the valuation allowance for held-for-sale loans is not being reduced below zero (that is, the allowance cannot have a debit balance).
  - b. Verify that valuation allowances are not being reported as part of the ALLL and that the valuation allowances are not included in tier 2 capital for risk-based capital purposes.
6. When the income or expense amounts relating to increases or decreases in the valuation allowance are material, ascertain, for financial reporting purposes, that the income and expense amounts are separately disclosed and appropriately described either on the face of the income statement or in the notes to financial statements.

## Held to Maturity

7. Determine if held-to-maturity debt securities are reported at amortized cost (paragraph 7 of FAS 115, as amended by FAS 140) in the statement of financial position only when the bank ensures its positive intent and ability to hold those securities to maturity.
8. Ascertain that the carrying value of assets held to maturity is adjusted to reflect the use of futures or forwards as bona fide hedges according to Statement of Financial Accounting Standards No. 133 (FAS 133), "Accounting for Derivative Instruments and Hedging Activities," as amended by Statement of Financial Accounting Standards No. 138 (FAS 138), "Accounting for Certain Derivative Instruments and Certain Hedging Activities." Determine if there is similar accounting treatment for firm commitments.
9. Determine if transfers from the warehouse to the permanent portfolio are accounted for at fair value.

## Mortgage-Servicing Assets

10. Determine whether purchased or assumed mortgage-servicing assets and liabilities are

initially measured at fair value (presumptively, the price paid).

11. Find out if mortgage-servicing assets or liabilities are amortized in proportion to and over the period of estimated net servicing income (servicing revenue in excess of servicing costs) or net servicing loss (servicing costs in excess of servicing revenue).
12. Determine if the notes to the financial statements disclose the following information on mortgage-servicing assets and liabilities:
  - a. the amounts of servicing assets and liabilities recognized during the period (including the amount of mortgage-servicing assets (MSAs) purchased)
  - b. the lower of the amortized cost or fair value of the recognized servicing assets and liabilities and the method and significant assumptions used
  - c. the method and amount of amortization for the reporting period
  - d. reasons for not estimating the fair value of MSAs and mortgage loans without MSAs
  - e. the risk characteristics of the underlying financial assets used to stratify recognized servicing assets for the purposes of measuring impairment
  - f. the activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate write-downs charged against the allowances—for each period for which results of operations are present

## Loan-Origination, Loan-Commitment, and Other Fees

13. Determine if management defers loan-origination fees (also points, placement fees, commitment fees, application fees, management fees, restructuring fees, and syndication fees), net of their costs over the remaining lives of their related loans or group of loans, as an adjustment of yield in accordance with Statement of Financial Accounting Standards No. 91 (FAS 91), generally using the interest method, which is based on the loans' contractual terms.



14. If a commitment expires unexercised, determine if the commitment fees are recognized as income upon the expiration of the commitment.

## MANAGEMENT INFORMATION AND COMMUNICATION SYSTEMS

1. Assess whether the management information system (MIS) has the capacity to handle existing volume and activities as well as projected strategies and objectives.
2. Determine if the MIS is capable of producing all necessary reports. Ascertain whether the reports—
  - a. identify closed loans as either held-to-maturity or held-for-sale;
  - b. segregate loans by product type and identify the dollar amount and percentage of total loans for each type;
  - c. monitor the volume of loan applications throughout the origination process;
  - d. identify the applications accepted, outstanding commitments and their delivery status, the effectiveness of hedges, and the historical fallout rates for specific loan categories;
  - e. monitor the status of the delivery of commitments to investors and the effectiveness of hedges; and
  - f. reflect the mortgage banking entity's daily position, including pipeline commitments, warehouse inventory, and forward sales contracts.
3. Assess the quality of reports that are presented to the board of directors. Determine whether the reports include or convey the following information in sufficient detail, given the size and complexity of the department:
  - a. liquidity and capital needs
  - b. various rate-shock scenarios and risk exposures
  - c. hedging activities, including products, results, and strategies
  - d. analyses of fair (mark-to-market) values, including the assumptions and documentation supporting those values
  - e. operating results, including profitability, efficiency, and cost information
  - f. asset-quality trends, including delinquencies, charge-offs, foreclosures, and collection accounts
  - g. production volume
  - h. inventory or warehouse aging (how long loans are in the warehouse or their turnover rate)
  - i. industry and peer-group performance statistics
  - j. policy, operating-procedure, and credit-quality exception reports
  - k. quality-control reports that discuss the analytical review of credit quality, loan characteristics and demographics, trends, and sources of problems (such as a deterioration in production quality and salability or weaknesses in internal controls that may not detect fraudulent activities)
    - l. processing backlogs
    - m. internal and external audit assessments of the effectiveness of the control procedures
4. Determine why management and board reports are deficient. Obtain management's responses to and the corrective actions taken for the deficiencies. Determine the causes for the deficient reports and whether any of the deficiencies stem from the following circumstances:
  - a. The reports contain inaccurate information, and the input and output of information has not been tested.
  - b. The necessary reports cannot be or are not generated.
  - c. Management is unfamiliar with the information system's capabilities.
  - d. Management is unfamiliar with the necessary monitoring of the reports.
5. Review investor-reporting requirements and determine the quality and extent of compliance with those reporting requirements. Investor reporting may vary depending on the servicing contracts in place, but typically the servicing bank is responsible for the following information:
  - a. detailed account reconciliations
  - b. information on the mortgagor's name, principal balance outstanding, and escrow balance
  - c. payment status and any foreclosure activity or transfers to the servicer's other real estate owned (OREO) account

## PRODUCTION

1. Review the guidelines for the loan-production area and determine if the guidelines address the following areas:



- a. types of loans that will be originated or purchased
  - b. sources from which the loans will be acquired, including sources from the Internet
  - c. underwriting standards, concentrations of credit, production channels, and production strategies
  - d. documentation requirements
2. Review organization charts to determine the structure of the production function. Verify that the functional units such as pipeline entry, processing, underwriting, closing, and funding are independent from one another.
  3. Find out the types of mortgage products offered, the actual product mix, and the nature of the bank's targeted markets. Evaluate portfolio trends with respect to any product, geographical income, or demographic or other higher-risk concentration.
  4. Ascertain whether operations risk has increased because of high management and staff turnover, an inability to meet investor-documentation requirements, an increase in the number of pools that have not received final certification, an unusually high cost structure, workloads that exceed capacity, and an increased loan delinquency.
  5. Find out whether the board has approved and management uses predetermined risk-tolerance levels. Evaluate whether credit risk (recourse and nonrecourse), interest-rate risk, or liquidity risk has increased because of operational inefficiencies and an inability to sell loans in the secondary market.
  6. Ascertain the nature of the mortgage banking entity's credit culture, compensation methods, and growth targets. Determine whether credit quality is weakened by an emphasis on income compensation versus loan volumes, aggressive or inappropriate lending strategies, relaxed credit standards, low documentation requirements, limited production channels, or geographic concentrations.
  7. Determine the level of and the reasons for nonconforming or unsalable loans and whether they present an undue level of risk. Determine whether the delinquency trends of such loans are being adequately monitored.
    - a. Ascertain how prices are determined.
    - b. Determine if the pricing strategy is typically at, above, or below fair (market) value.
    - c. Assess the impact that pricing strategies have on current and future profitability.
  8. Determine the frequency of price changes for retail, wholesale, and broker channels by reviewing historical price sheets. Evaluate the timing of changes relative to significant market interest-rate movements.
  9. Find out if the secondary marketing manager determines any new product's marketability and pricing strategy. Determine if the marketing manager overly influences the bank's ability to price, deliver, and service the product.

### Origination and Underwriting

10. Review the policies and procedures for loan originations.
  - a. Determine if the originators' compensation is highly dependent on loan volume and if that sacrifices loan quality.
  - b. Find out if originators can alter established pricing parameters set by the secondary marketing unit.
  - c. To ensure objectivity, verify that the underwriting unit does not report to production-function management.
11. Review the qualification levels of underwriters (their education, experience, training, and certification credentials).
12. Determine the methods used to evaluate loan originations.
  - a. Review the compensation programs of the bank's mortgage banking entity. Determine if the compensation program is based on normal loan-origination volumes and on qualitative factors such as loan quality and fully completed applications (including the documentation on liens, adequate values of collateral, and thorough documentation of the applicant's financial information that supports the originator's determination that the potential borrower has the financial capacity to repay the loan).
  - b. Find out if management holds originators accountable for weak loan quality and credit risk.
13. Determine if adequate control processes are in place for front-end and post-closing loan documents. Find out if the processing activities are controlled through the use

- of standardized procedures, checklists, and systems.
14. Review a representative sample (that is, a statistical sample) of current loans to test the underwriting policies and procedures. Determine the validity and adequacy of documentation supporting loans held for sale or investment.
  15. Determine whether notifications to management on withdrawn mortgage applications are sufficient to allow for proper hedging strategies.
  16. Determine how management monitors originators' adherence to underwriting and investor guidelines.
  17. If underwriting is performed in-house, determine if management establishes, reviews, and monitors approval limits, exception standards, and documentation procedures for loans that are rejected or suspended. Find out if management receives and reviews adequate current reports tracking the quality of loans for each underwriter.
  18. If a scoring underwriting system is used, review the credit scoring methodology and determine if the system can be overridden and by whom.

## Overages

An overage exists when a lender permits an originator or a broker to impose a higher number of points (or a higher interest rate) on a loan to certain borrowers than is imposed for the same product offered to other borrowers at a given point in time. The amount of overage that is received is usually shared between the mortgage banking entity (the originator) and the broker. Overages are often referred to as *yield-spread premiums* (YSPs).

19. If the bank's mortgage banking entity is involved in overage activities, determine if management has developed comprehensive policies and procedures, detailed documentation and tracking reports, accurate financial reporting systems and controls, and comprehensive customer complaint tracking systems to adequately monitor and supervise overage activities.
20. Since the previous examination, determine if overage activities are an essential component of the mortgage banking entity's earnings. Find out the percentage of originations

that resulted in overages and the average overage per loan.

21. Ascertain whether overages are a major component of loan officer or broker compensation.
22. Determine whether overages were reviewed during the last consumer compliance fair lending examination and whether any recommendations were made regarding overage activities.

## Closing

23. Evaluate procedures for closing loans. Ascertain whether adequate analyses are prepared and if any allowances are established for estimated probable losses arising from documentation deficiencies on closed loans.
24. Determine if management requires that necessary and required documents be obtained and properly signed before funds are released.
25. Evaluate management's controls over the loan-funding process.
26. Assess management's plans for funding originations during peak volume periods.
27. Determine if a post-closing documentation-review process exists to differentiate, track, and obtain both trailing and missing documents.

## Wholesale and Correspondent Loan Production

28. Determine if the bank has adequate control processes in place to monitor and manage the risks associated with purchasing third-party-originated loans and approvals (controls include management's close supervision of underwriting that is delegated to brokers or correspondents).
  - a. Find out if the bank's reporting systems monitor and manage—
    - the quality of mortgages purchased from wholesale and other third-party sources and
    - the methods used to evaluate the loans on an ongoing basis.
  - b. Determine if controls over the independent appraisal and underwriting process are adequate and if due diligence over

- third-party relationships is adequate to prevent poor-credit-quality loan originations, including fraudulent originations.
29. Review the policies and procedures for wholesale and hybrid purchases.
    - a. Find out the production channels that are used and how they perform. (The channels may include whole loan purchases (production flow) or hybrid purchases such as table funding, assignment of trade, or co-issuances (bulk purchases of servicing assets).)
    - b. Determine the nature and extent of the compensation of brokers and correspondents for each production channel.
  30. Review the bank's approved list of wholesale sources of loans. Determine the types and dollar volume of loans purchased from each wholesale source. Investigate any purchases from sources not on the approved list.
  31. Determine management's process for evaluating and monitoring the quality of loans purchased from wholesalers. Ascertain whether the process considers the following:
    - a. historical default and foreclosure levels
    - b. nondelivery history
    - c. HUD, Fannie Mae, FHLMC (Freddie Mac), or GNMA investor status (when applicable)
    - d. documentation deficiencies
    - e. financial statements
  32. Determine if the bank underwrites mortgages purchased from wholesale sources.
    - a. If the bank delegates underwriting responsibilities to a correspondent or a third party, determine and evaluate the adequacy of the process for reviewing and monitoring the quality of mortgages purchased.
    - b. Find out if—
      - post-purchase reviews adequately assess the loan quality and completeness of the documents;
      - the bank maintains records of post-loan-purchase reviews, including the volume of loan rejections from each source; and
      - the bank frequently returns to the seller noncompliant loans (loans not meeting contractual requirements) purchased from wholesale sources.
  33. Ascertain what methods are used for reviewing and approving brokers and correspondents and what the specific programs are. Determine which loans are purchased.
    - a. Determine if there is an approved list of correspondents and how the list is updated.
    - b. If there are deviations from the list, determine who authorized them and if there are controls to prevent unauthorized purchases.
  34. Find out if financial reviews of the correspondents are conducted, who conducts the analysis, and how frequently analyses are conducted. Determine whether adequate controls are in place to detect changes in the financial condition of a correspondent, test and monitor the quality of loans purchased, and evaluate the correspondent's financial capacity to perform under contractual repurchase agreements.
  35. Ascertain how the bank manages funding and liquidity risk for wholesaling mortgages.
    - a. Determine if the collateral is received before payment.
    - b. Determine what controls are in place to prevent unnecessary loss exposures.

## PIPELINE, WAREHOUSE, AND HEDGING ACTIVITIES

1. Review the written policies and procedures for pipeline, warehouse, and hedging activities.
  - a. Determine the process for granting exceptions (including the prior-approval requirements and whether the policy exceptions are reported to the asset/liability committee) that are contrary to the established lending policies and limits.
  - b. Find out if the policies define the following criteria:
    - position and earnings-at-risk limits
    - permissible hedging activities
    - individuals authorized to engage in hedging activities
    - fair (market) values
2. Evaluate the effectiveness of the lending limits, approval requirements, MIS reports, and pipeline or warehouse hedging strategies to identify, monitor, measure, and control risks.
3. Determine if an appropriate separation of duties exists for the pipeline, warehouse,

- and hedging process. Ascertain whether there are proper controls in place for the various phases of each process.
4. Ascertain whether the control systems exist to ensure that the fair (market) value determinations are performed by a person who is not directly responsible for pipeline and warehouse hedging activities.

## Pipeline Management

The pipeline consists of applications approved but not yet funded. Typically, two types of loans are in the pipeline: rate-locked and floating-rate. The key to effective hedging of pipeline loans is predicting the fallout rates of rate-locked loans (the rate at which approved, rate-locked loans will *not* be funded).

5. Review the methodology used and the adequacy of its documentation to predict the volume of loan applications that are expected to “fall out” of the mortgage pipeline.
6. Find out how management tracks the bank’s loan-fallout activity and how the tracking process and information are used to control and lessen the risks associated with its hedging activities.
7. Review the reports on pipeline management that provide the pipeline-fallout ratios for each type of loan product. Assess the effect of unanticipated fallouts on the results of hedging activities.
8. Review the frequency and accuracy of pipeline-commitment reporting. Find out how pipeline commitments are identified (including by their product type and interest rate, and the separate identification of the locked-rate and floating-rate commitments) and reported on MIS reports.
9. Review the signed pipeline-commitment reconciliations and verify that they are prepared monthly. Compare them against the pipeline position reports.
  - a. Determine if commitments are specifically identified by product type and interest rate.
  - b. Determine if rate-locked commitments and floating-rate commitments are separately identified and tracked.
  - c. Determine what management’s process is for handling expired rate-lock commitments.
10. Determine if pipeline commitments are accurately disclosed in the notes to the financial statements and in reports of condition.
11. Review management’s procedures for monitoring and projecting the volume of applications that are expected to fall out of the mortgage pipeline.
  - a. Determine how the fallout rates correspond to hedging practices.
  - b. Determine whether management assumptions relative to loans that will not close equate to the hedging practices in place.
  - c. Ascertain if the bank uses simulation models to predict fallout percentages and to determine hedging strategies, which are dependent on the interest-rate environment.
12. If the bank has been unable to meet mandatory commitments, determine if management purchased loans from other sources or paid investors a pair-off fee.
  - a. Determine if the situation was reported to the board of directors or a board committee.
  - b. Ascertain the reasons why the bank was unable to meet mandatory commitments.

## Warehouse Management

Warehouse loans are funded loans waiting to be delivered to the secondary market.

13. Review internal warehouse-reconciliation reports, which should be prepared at least monthly.
  - a. Assess the adequacy of controls over the warehouse account.
  - b. Determine if errors are promptly corrected (errors such as mortgages that are funded more than once or mortgages that are funded but not closed).
14. Review warehouse-turnover and -aging reports, which should be prepared at least monthly.
  - a. Determine if mortgage loans are removed from the warehouse within a reasonable period of time (usually 90 days or less).
  - b. Find out why loans are remaining in the warehouse for a longer period.
15. Ascertain whether any warehouse loans are being held beyond the bank’s normal time frames in anticipation of improved market conditions. If the bank is taking specula-

- tive positions with warehouse inventory, determine if the positions are within the approved dollar limits. (Loans held for sale are typically newly originated credits and are normally held in the warehouse only for a short period of time; therefore, delinquencies and protracted holding periods are not normal.)
16. Review management's methods for handling warehouse loans that are ineligible for sale. Find out if a significant volume of ineligible loans is being placed in the bank's held-for-investment loan portfolio because they are delinquent, have documentation problems, or have other weaknesses. If the volume of ineligible loans is significant, determine the methods used for handling the resolution of such loans.
  17. Assess management's strategies for hedging pipeline or warehouse loans, the characteristics of these loans (such as adjustable-rate-mortgages (ARMs) or loans with interest-rate caps and floors), and the types of hedging instruments used.
    - a. Review actual hedging practices and ascertain if they conform with established policy limitations and guidelines.
    - b. Obtain and review the hedging information provided to executive management and the board of directors.
      - Evaluate whether hedging practices are properly approved and adequately supervised.
      - Determine if the board of directors approves all hedging strategies and the individuals who perform them.
  18. Review the effectiveness and financial results of hedging strategies, such as the use of forward sales or options, to hedge risks associated with rate-locked commitments in the pipeline. (Some banks may not hedge interest-rate risk associated with rate-locked loans.)
    - a. Determine management's strategies for hedging loans with special risks (such as ARMs or loans with interest-rate caps or floors).
    - b. Find out if the bank is assuming excessive basis risk for any hedging product.
    - c. Determine if correlation is used to analyze the bank's hedging strategies (to measure the degree of correlation between the hedge product and the underlying position being hedged, and the degree of risk each strategy or position entails).
  19. Find out if call options are written to enhance inventory levels. If so, verify that they are written against covered positions. Ascertain whether management is speculating in any way and whether this activity subjects the bank and its mortgage banking entity to undue risk.
  20. Review recent profit or loss reports for mortgage banking hedging activities. Assess the effectiveness of the hedging strategies on mortgage banking operations, including the use of such strategies to offset the risk inherent in funded but unsold loans.
  21. Review management reports relating to pipeline and closed-loan hedging operations.
    - a. Determine whether the reports are complete, accurate, and timely.
    - b. Analyze whether the reports are effective in adequately limiting excesses, recording exception approvals, and detailing the risk exposures.
  22. Find out if the bank uses any simulation models to establish risk limits and hedging strategies.
    - a. Determine if the simulation assumptions are reasonable and if the volatility assumptions are consistent with the market.
    - b. Find out how frequently the assumptions and other model inputs are reviewed, tested, and updated.
    - c. Ascertain if budget and management decisions are included in the model's assumptions and the extent to which they are incorporated.
  23. Determine if management adequately assesses counterparty risk and establishes appropriate limits.
  24. Determine if hedging instruments are accurately and properly disclosed in the notes to the bank's financial statements and in its reports of condition.
  25. Find out from discussions with management what systems the board of directors has authorized for use in—
    - a. measuring, controlling, and hedging interest-rate risk;
    - b. defining the level of interest-rate risk the bank's board is willing to accept; and
    - c. specifying the hedging and other current or future strategies for achieving and

- maintaining the bank's desired goals. (Depending on the current and forecasted interest-rate environment and projected fallout rates, management may be either over- or underhedging pipeline and warehouse loans.)
26. Determine and evaluate the adequacy of the internal controls in place to oversee hedging activities (controls include monitoring the effectiveness of the authorized hedging strategies and reviewing hedged-instrument concentrations and counterparties).
  27. Review MIS reports relating to hedging strategies. Verify that the reports are accurate, adequate, current, and complete and are prepared regularly.
    - a. Verify that the reports sufficiently detail risk exposures.
    - b. Review reconcilements of outstanding trades to the daily position report.
  28. If hedging strategies are ineffective, determine if the following situations are the cause:
    - a. poor correlation of data
    - b. unreliable data
    - c. speculation
  29. Determine if the following controls over forward sales activities exist:
    - a. Traders are prohibited from entering forward sales data into the system, and individual trade tickets are required to be prepared and submitted to an independent unit for processing.
    - b. Third-party trade confirmations are received and reviewed by a separate, independent unit.
    - c. The bank has established prudent follow-up procedures for unconfirmed trades and confirmation discrepancies. Management uses the follow-up procedures to resolve or correct any unconfirmed trades or discrepancies.
- prevented from overly influencing or dominating pricing decisions.
- b. Review the current list of mortgage-product offerings and the daily price sheet. Find out if the prices are determined centrally and are uniform.
  - c. Ascertain whether the pricing methods and procedures used are consistent with the bank's strategic plans.
  - d. Find out from management what pricing strategies it uses; whether mortgages are priced using comparative security-price screens; and if the mortgages are priced neutrally or above, below, or at their fair (market) values.
  - e. Using management's pricing analysis, ascertain whether management makes its pricing decisions on the basis of the bank's competitors, the overall costs of loan production and secondary marketing, and the value of servicing assets that are generated. Evaluate the current and future profitability impact of the bank's pricing decisions.
2. Find out the change in pricing frequencies for retail, wholesale, and broker channels. Evaluate the timing of pricing changes relative to significant market interest-rate movements.
  3. Determine what procedures are in place to ensure that deviations from the approved pricing policies receive the proper degree of scrutiny and approval by senior management.
    - a. If deviations are common, determine why they are occurring. (For example, are they occurring because of competition, compensation schemes, or departmental profitability considerations or targeted goals?)
    - b. Ascertain what impact the deviations have had on the mortgage banking entity's production volumes and profitability.
  4. Find out what policies are in effect for governing customer rate locks.
    - a. Determine if rate locks expire, automatically renew, or are renegotiated at current interest rates.
    - b. Ascertain whether the number and dollar volume of loans with expired rate locks are adequately monitored, tracked, and controlled.

## SECONDARY MARKETING

### Mortgage Pricing

1. Review the mortgage-pricing methods and procedures to find out how the prices for mortgages are established.
  - a. Determine if the secondary-market unit is responsible for setting mortgage prices and if the mortgage originators are



## Selling Mortgages

5. Find out what marketing programs are used to sell mortgages to investors. Review and assess the financial impact of these programs on sales volume.
6. Sample and review the larger-investor master sales commitments:
  - a. Review investors' requirements for underwriting, delivery, documentation, and servicing.
  - b. Determine the amount, maturity, and terms of the commitments.
  - c. Determine whether the bank has been able to meet investors' requirements and the mandatory sales commitments. If not, determine the potential financial exposure to the bank.
7. Determine the number of sold loan pools that lack final pool certification, the reasons why, and if the mortgage banking group was required to post a letter of credit.
8. Determine if the bank participates in a mortgage-backed security swap program. Review the terms of the swap agreements and determine if any of the terms are financially detrimental to the bank.

## Recourse Transactions and Obligations

9. Review a sample of sales contracts and servicing agreements to determine if the bank has any continuing recourse obligations to the purchaser beyond normal representations and warranties.
10. When loans are sold with recourse, determine if—
  - a. the bank has adequate MIS to track all recourse obligations;
  - b. management is adequately identifying and managing the risk associated with recourse obligations;
  - c. the bank is negotiating the assumption of excess risk in exchange for lower guarantee fees;
  - d. reserve levels are adequate for loans sold with recourse (see FAS 140); and
  - e. management properly accounts for all loans sold with recourse in the bank's reports of condition.

## MORTGAGE SERVICING

### Portfolio Supervision

1. Review the written policies and procedures for mortgage loan servicing and determine if they adequately cover all facets or functional areas of the servicing operations.
  - a. Determine whether reports to management adequately monitor compliance with the established policies and procedures.
  - b. Determine how exceptions to the policies and procedures are identified and addressed.
2. Review a sample of investor-account reconciliations and determine if—
  - a. each investor account is reconciled at least monthly,
  - b. outstanding items are resolved in a timely manner,
  - c. management regularly charges off stale, unreconciled items, and
  - d. a supervisor reviews and approves the reconciliations.
3. Review and determine the accuracy and adequacy of the most recent management reports that state operating results for the servicing unit. Determine if the details provided are adequate to supervise the servicing function.
4. Review the most recent analysis of servicing revenues and costs for the primary product types. Ascertain whether costs are estimated and prepared on an average or incremental basis.
  - a. Determine if management's analysis of revenue considers all sources of revenue, including contractual servicing fees, ancillary fees, and the benefits derived from compensating balances from custodial funds.
  - b. Assess the adequacy of the servicing unit's current and projected profitability. Determine if management analyzes profitability on a product-by-product basis and how this analysis is factored into strategic decisions.
  - c. Determine if management's cost analysis includes all direct and indirect servicing expenses.
5. Review the list of outside vendors and subservicers the bank employs to perform servicing functions.

- a. Determine how management assesses (at least annually) the quality of work performed by outsiders.
  - b. Find out if management regularly reviews and evaluates the financial condition of each vendor or servicer.
  - c. Ascertain whether the bank has a contingency plan to ensure it fulfills servicing responsibilities if a vendor or servicer fails to perform.
6. Evaluate the asset quality of the servicing portfolio.
    - a. Review the reports on the volume of delinquencies, foreclosures, bankruptcies, losses, and other real estate owned that have been prepared since the previous examination. Assess the extent and impact of those reported results on profitability and financial performance.
    - b. Determine the extent and impact any geographical credit concentrations have had on profitability and financial performance.
  7. Determine if complaints are appropriately resolved. Review significant complaints to ascertain if there are any possible internal control deficiencies or substantial legal risks.
  8. Determine if the bank has purchased loans from the servicing portfolio.
    - a. Determine if appropriate policies and procedures governing the purchases are in place.
    - b. Determine the reasons for the purchases.
    - c. Analyze the volume and trend of purchases.
  9. Review the procedures for receiving payments from borrowers, depositing funds into segregated custodial accounts, and remitting funds to investors.
    - a. Assess the bank's system for ensuring borrowers' payments are accurately applied and ensuring investors receive payments on schedule.
    - b. Determine if adequate controls exist over custodial accounts (controls include daily balancing, monthly reconcilements, authority for disbursements, and segregation of administrative duties).
  10. Review written servicing agreements to determine investor-servicing requirements, funds remittance schedules, contractual servicing fees, guarantee fees, and servicer representations and warranties.
    - a. Determine if loan delinquencies have prompted the use of bank funds to meet remittance requirements.
    - b. Track the timeliness of the flow of funds at the investors' cutoff dates, the dates of remittance of funds to investors and security holders, and the recognition dates of servicing revenue.
  11. Assess the adequacy of the system for ensuring the timely payment of taxes, insurance, and other obligations of the borrower.
  12. Find out what methods are used for correcting shortages and surpluses in escrow accounts.
  13. Review the procedures for ensuring that tax and insurance payments are made on delinquent loans.
  14. Assess the methods used to evaluate the financial condition of subservicers.
  15. Evaluate the servicer's and subservicer's agreements as to their responsibilities, reporting requirements, performance, and fees. Verify that management confirms that no additional liabilities, real or contingent, are being (or can be) imposed on the bank's mortgage banking entity beyond its responsibilities as a servicing agent.

### Mortgage-Servicing Assets

16. Determine if and the extent to which mortgage-servicing assets (MSAs) are reviewed by the external auditors.
17. Review management's procedures for initially recording, amortizing, and periodically re-evaluating MSAs. Verify that reports of condition and income reflect quarterly revaluations of MSAs. Determine if the procedures require MSA documentation of—
  - a. the methods employed for assigning a relative fair value to each MSA asset, specifically, the assumptions and procedures used (which should incorporate assumptions that market participants would use) to derive fair value;
  - b. the recording of the fair value of MSAs and their amortization in proportion to and over the period of their estimated net servicing income or loss (a valuation allowance must be established if costs exceed the fair value);
  - c. the systems for recordkeeping and impairment testing;
  - d. the policies, procedures, and operating



- requirements for the ongoing supervision of MSAs;
- e. at least quarterly reviews of the book values of MSAs to determine if they are recorded at their fair values;
  - f. the procedures to ensure compliance with other accounting and regulatory requirements, investor criteria, and internal policies;
  - g. the stratification of MSAs into groups based on one or more of the predominant risk characteristics of the underlying financial assets to determine the fair value of the MSAs;
  - h. the recognition of an impairment when the book value of a stratum of a servicing asset exceeds the asset's fair value, and the adherence to the accounting requirement that the book value be reduced to fair value through a valuation allowance for that stratum;
  - i. the validation process to ensure that the actual performance of MSAs is compared with their predicted performance;
  - j. the procedures to ensure that the fair (market) value or valuation assumptions used for the impairment analysis are current and reasonable and that they reflect the expected levels of mortgage prepayments and market discount rates (When checking impairment, ensure that the bank's test uses the current (not the original) level of servicing fees (prepayments on the underlying loans cause the weighted average coupon (WAC) to change, which changes the level of servicing over time.);
  - k. management's review and approval of the results and assumptions employed; and
  - l. the process to determine when and how adjustments should be made to the respective valuation allowance on the basis of the results of impairment analyses.
18. Evaluate the due-diligence process for bulk acquisitions of purchased MSAs, if applicable.
    - a. Determine if the bank performs a comprehensive due-diligence review before purchasing a servicing portfolio.
    - b. Determine if management applies and documents reasonable valuation assumptions (documentation includes data on the underlying mortgages, servicing revenues and costs, prepayment speeds, and discount rates as well as explanations of how the particular valuation assumptions used were determined).
    - c. Verify that management is properly reporting MSAs in Schedule RC-M of the bank's report of condition and is reporting the results of the MSA transactions in its report of income.
  19. Determine if management separately identifies servicing assets and any related interest-only strips receivables.
  20. Review MSAs recorded as a result of retail production (originated) or purchased activities.
    - a. Determine if the bank obtains commitments to resell the mortgages before or within 30 days of their purchase.
    - b. Confirm that the purchase or origination cost of the loans and their MSAs are based on quoted market prices or the best available information, considering the prices for similar assets and asset-valuation techniques (such as estimating the future cash flows using a discount rate that is commensurate with the risks involved). Other valuation techniques include option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analyses.
    - c. If other valuation techniques are used, determine if they are consistent with the objective of measuring fair value and if they incorporate assumptions that market participants would use when estimating future servicing income, including assumptions about prepayment, default, and interest rates.
    - d. Find out if the mortgage banking entity is allocating costs to mortgage-servicing rights when it is practicable to estimate the fair value of those rights and the related mortgage loans. If not, determine that the MSAs are recorded at zero and if they are disclosed in the bank's financial statements. (The reasons why it was not practicable to estimate their fair values should also be disclosed.)
  21. Complete an in-depth review of the valuations that are based on the fair (market) values for MSAs.
    - a. Determine if management identifies the characteristics of the servicing portfolio, specifically the following items:
      - investors

- types of products
  - transactions made with or without recourse
  - geographic dispersion of borrowers
  - average loan size
  - range of interest rates
  - projected life and average age of loans
  - delinquency, foreclosure, OREO, and bankruptcy levels
  - loss experience
- b. Review prepayment-speed assumptions to determine if they are realistic and conform to acceptable industry standards.
  - c. Determine if the discount-rate valuation assumptions used to estimate future cash flows are realistic and in line with industry practices.
22. Request that management recalculate the fair value of any MSAs if the assumptions used are unrealistic and examiners believe the reported MSA values are materially overstated (if the bank's internal model is considered reliable, it may be used to recalculate the MSA's value, after substituting more realistic assumptions). Following the recalculation of these fair values, review the assumptions used. Evaluate and verify the results.

## Collections

23. Review policies and procedures for collecting delinquent loans.
  - a. Determine if collection efforts follow investor guidelines.
  - b. Determine if the bank documents all attempts to collect past-due payments.
  - c. Determine if the bank charges off uncollectible balances in a timely manner.
24. Review loan-delinquency reports. Select and review a sample of files for severely delinquent borrowers (particularly those borrowers over 120 days delinquent).
  - a. Determine if the bank initiates foreclosure proceedings in a timely manner and properly notifies borrowers and investors.
  - b. Review a sample of loans in which the foreclosure action is delayed due to forbearance agreements. Determine if the agreements are within investors' guidelines.
25. Review a sample of investor-owned OREO properties to determine if administrative

and marketing practices comply with investor guidelines.

26. Determine if there are any contingencies resulting from the improper administration of foreclosed properties.

## FINANCIAL ANALYSIS

### Financial-Statement Level and Trends

1. If separate-unit or subsidiary financial statements are prepared for the mortgage banking entity, perform a volume and trend analysis of the entity's financial condition and performance for the current and previous two-year period. Pay particular attention to any comparative disparities that fall within the current examination period.
2. Review any of the mortgage banking entity's primary or large balance-sheet and income-statement categories or items that may represent or pose significant financial or other risk concentrations. Investigate any items or categories that pose undue financial or other risks. Discuss these categories or items with management and the internal and external auditors.
3. Determine whether the analyzed financial trends are consistent with the economic environment, interest-rate movements, the bank's business orientation, and management's intended growth strategy.
4. Determine whether reports filed with the Federal Reserve (or other federal regulatory departments, agencies, or government-sponsored agencies that are directly involved with mortgage banking or asset securitizations involving real estate) are prepared accurately and submitted in a timely manner. Pay particular attention to the reporting for mortgage-servicing assets and recourse obligations retained by the mortgage banking entity.

### Earnings Performance and Profitability

5. Using ratios and industry comparisons, analyze and evaluate the mortgage banking entity's earnings performance in terms of the level, composition, and trend of net income. Consider internal factors such as

- the entity's business orientation and management's growth plans. Also consider external factors such as interest rates, the economic environment, and industry performance trends. (Ratios that compare earnings to total assets or equity are of limited use unless the examiner also considers the transitory nature of the balance sheet and the impact of off-balance-sheet servicing activities on the company's use of financial leverage.)
6. Review and discuss with management and internal or external auditors any unusual aspects of origination and servicing-fee income, marketing gains and losses, the net interest margin, reserves, write-downs or adjustments in MSA amortization, salaries and overhead items, or income taxes.
  7. Evaluate officer-compensation arrangements that are tied to the department's or bank's profitability. Ascertain whether any of the compensation or incentive programs pose significant financial burdens or risks to the extent that they materially affect the institution's profitability or that they promote unsafe or unsound practices.
  8. Investigate the causes for operating losses in the mortgage banking entity's operations and evaluate the prospects for profitability.
    - a. Determine if elevated operating costs or other inefficiencies are impairing profitability.
    - b. Establish whether excessive borrowing activities have led to adverse changes in the cost of funds. Ascertain what impact a change in the cost of funds would have on the net interest margin.
    - c. Determine why hedging strategies have not appropriately controlled interest-rate risk.
  9. Evaluate management's process for meeting the liquidity needs of the mortgage banking department, considering the size of loans in the pipeline and the warehouse as well as the nature and extent of other longer-term assets.
  10. Determine whether liquidity sources are adequate for current conditions and projected funding needs.
    - a. Evaluate the methods used to fund mortgage operations. Funding methods may include repurchase agreements, commercial paper, revolving warehouse lines of credit, and long-term debt.
    - b. Review asset and liability management practices to determine if funding maturities approximate the maturities of underlying assets.
  11. Determine whether sources of liquidity are adequate under both current conditions and economic duress. Consider earnings performance, capital adequacy, the degree of market contact with underwriters and credit rating agencies, the maintenance of debt covenants, and contingent liquidity-planning capabilities.
  12. Evaluate the financial instruments used to fund mortgage operations. Financial instruments may include repurchase agreements, commercial paper, revolving warehouse lines of credit, or long-term debt (or a combination of these instruments). Review related credit agreements and the systems used to monitor compliance with debt covenants.
  13. Evaluate whether excessive borrowing activities have led to a highly leveraged financial position that exposes the company to money market changes in the cost of funds. Assess what the impact would be if there were a change in the bank's and the mortgage banking entity's cost of funds.
  14. Determine the degree of financial flexibility the bank and mortgage banking entity maintain.<sup>1</sup> Ascertain whether the bank and mortgage banking entity possess adequate financial strength and whether they have sufficient access to lines of credit or assets (or both) that can be easily collateralized to readily obtain borrowed funds.
  15. Review the net current items on the cash-flow statement pertaining to cash flow from

### Analysis of Risk, Liquidity, and Funding

9. Determine which risks associated with mortgage banking, such as credit risk, interest-rate risk, price risk, transaction risk, liquidity risk, compliance risk, and strategic risk, pose the most material threat to earnings, capital, and liquidity. Determine whether the bank complies with SR-96-13 and the June 26, 1996, Joint Agency Policy Statement on Interest Rate Risk.

1. Financial flexibility is the ability to obtain the cash required to make payments as needed.

operations, cash flows from investing activities, and cash flows from financing activities on a year-by-year trend basis. From the level of current transactions, determine whether sufficient positive cash flow exists. (The summary analysis of the cash-flow statement should convey how the underlying transactions collectively contribute to a positive cash flow and liquidity.)

17. Review asset and liability management practices to determine whether funding maturities closely approximate the maturities of underlying assets or whether any funding mismatches exist. Determine if the bank and its mortgage banking entity are exposed to short-term interest-rate fluctuations that may result in significant earnings volatility if interest rates change rapidly.

## INTERCOMPANY TRANSACTIONS

Follow the examination guidance, instructions, and procedures in sections 4050.1, 4050.2, 4050.3, and 4050.4 that apply to Federal Reserve Act sections 23A and 23B and Regulation W.

1. Review the following transactions between the bank and its affiliates. Determine if there is compliance with the applicable determinants of control, quantitative and other limitations, and collateral and valuation requirements of Federal Reserve Act section 23A and Regulation W.
  - a. loans or extensions of credit
  - b. purchases of securities or assets
  - c. the bank's issuance of a guarantee (credit enhancements, cross guarantees, and keepwell agreements), an acceptance, or a letter of credit on behalf of the mortgage banking entity or its affiliate
  - d. the acceptance from a third party of securities issued by an affiliate (including mortgage-backed securities) as collateral for a loan
  - e. purchases of low-quality assets by the bank
  - f. merger and acquisition transactions
  - g. transactions with third parties when the proceeds are transferred to or used for the benefit of an affiliate
2. Review the following intercompany and affiliate transactions. Ascertain whether there are any underlying reasons (for example, non-independent credit reviews, transfers

being classified as purchases, blanket advance-purchase commitments, no evidence of providing consideration, absence of safe and sound banking practices, etc.) why the following mortgage bank and intercompany or affiliate transactions do not qualify for the applicable exemptions found in section 23A or Regulation W:

- a. transactions involving sister bank
- b. transactions giving immediate credit for uncollected items in the ordinary course of business
- c. loans, guarantees, acceptances, or lines of credit secured by segregated, earmarked deposits or U.S. or U.S.-guaranteed obligations
- d. asset purchases that have a readily identifiable and publicly available market quotation
- e. transfers of subsidiaries to the bank
- f. asset purchases on a nonrecourse basis if—
  - the extension of credit was originated by the affiliate;
  - the member bank makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes or commits to make the extension of credit;
  - the member bank commits to purchase an extension of credit before the affiliate makes or commits to make the extension of credit;
  - the member bank does not make a blanket advance commitment to purchase extensions of credit from the affiliate; and
  - the dollar amount of the extension of credit, when aggregated with the dollar amount of all other extensions of credit purchased from the affiliate during the preceding 12 calendar months by the member bank and its depository institution affiliates, does not represent more than 50 percent (or such lower percent as imposed by the member bank's appropriate federal banking agency) of the dollar amount of extensions of credit originated by the affiliate during the preceding 12 calendar months.
3. Review the following intercompany, affiliate, or covered transactions for compliance with section 23B of the Federal Reserve Act, including its competitive terms and conditions requirement.

- a. all transactions subject to section 23A
- b. any transaction in which the proceeds are used to benefit the mortgage banking nonbank subsidiary or entity
- c. sales of securities or assets to another affiliate, including those sales subject to an agreement to repurchase
- d. payments of money or the furnishing of services to an affiliate under contract, lease, or otherwise
- e. transactions in which the mortgage banking nonbank subsidiary or entity acts as agent or broker or receives a fee for providing services to the bank
- f. transactions with a third party if the mortgage banking subsidiary or entity has a financial interest in the third party or participates in the transaction
- g. purchases of assets as a fiduciary
- h. purchases of securities underwritten by the bank as the principal underwriter
- i. transactions or advertisements whereby the bank assumes responsibility for an affiliate's obligations

of its capital adequacy. Ascertain how the bank's analysis relates to the determination of its risk-weighted assets and the levels of risk attributable to the mortgage banking entity, compared with the entity's accumulated earnings and other contributions to the bank's capital. Determine if the mortgage banking entity is providing sufficient capital resources to support the overall level of risk arising from its operations, without having a negative impact on the bank's level of capital attributable to its other operations.

3. Determine if the mortgage banking entity's assets (including MSAs) and risks (on- and off-balance-sheet) are correctly computed and quantified as part of the bank's overall determination of compliance with the risk-based capital adequacy guidelines (12 CFR 208, appendix A) and the tier 1 leverage capital adequacy guidelines (12 CFR 208, appendix B). Follow and apply the applicable examination guidance and procedures in sections 3020.1, "Assessment of Capital Adequacy," and 4030.1, "Asset Securitization."
4. Determine whether a written capital-generation plan or policy has been developed, approved, and reviewed at least annually by the board of directors. The plan should specify what capital-generation levels are needed to support the mortgage banking entity's current operations and projected future growth, given the prescribed risk-tolerance levels that arise from the bank's mortgage banking transactions and activities.

## CAPITAL ADEQUACY

1. Ascertain whether management has periodically verified that the mortgage banking entity meets the nominal capital levels required by investors (Fannie Mae, Freddie Mac, etc.) and meets any additional required capital for loans serviced for investors, on the basis of the bank's financial reporting under generally accepted accounting principles.
2. Review the bank's computation and analysis

# Real Estate Appraisals and Evaluations: Appendixes A–D

Effective date April 2011

## Section A.4140.1

### APPENDIX A—APPRAISAL EXEMPTIONS

*This appendix provides a commentary on the twelve exemptions from the agencies' appraisal regulations. The appendix provides an explanation of the agencies' statutory authority to provide for appraisal regulatory exemptions and the application of these exemptions.*

Under title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the agencies were granted the authority to identify categories of real estate–related financial transactions that do not require the services of an appraiser to protect federal financial and public policy interests or to satisfy principles of safe and sound lending. Therefore, in their appraisal regulations, the agencies identified certain real estate–related financial transactions that do not require the services of an appraiser and that are exempt from the appraisal requirement. This appendix provides further clarification on the application of these regulatory exemptions and should be read in the context of each agency's appraisal regulation. If an institution has a question as to whether a particular transaction qualifies for an exemption, the institution should seek guidance from its primary federal regulator. For those transactions qualifying for the appraisal threshold, existing extensions of credit, or the business loan exemptions, an institution is exempted from the appraisal requirement but still must, at a minimum, obtain an evaluation consistent with the guidelines presented in section 4140.1 of this manual.

#### 1. Appraisal Threshold

For transactions with a transaction value equal to or less than \$250,000, the agencies' appraisal regulations, at a minimum, require an evaluation consistent with safe and sound banking practices. If an institution enters into a transaction that is secured by several individual properties that are not part of a tract development, the estimate of value of each individual property should determine whether an appraisal or evaluation would be required for that property. For example, an institution makes a loan secured by seven com-

mercial properties in different markets with two properties valued in excess of the appraisal threshold and five properties valued less than the appraisal threshold. An institution would need to obtain an appraisal on the two properties valued in excess of the appraisal threshold and evaluations on the five properties below the appraisal threshold, even though the aggregate loan commitment exceeds the appraisal threshold.

#### 2. Abundance of Caution

An institution may take a lien on real estate and be exempt from obtaining an appraisal if the lien on real estate is taken by the lender in an abundance of caution. This exemption is intended to have limited application, especially for real estate loans secured by residential properties in which the real estate is the only form of collateral. In order for a business loan to qualify for the abundance of caution exemption, the agencies expect the extension of credit to be well supported by the borrower's cash flow or collateral other than real property. The institution's credit analysis should verify and document the adequacy and reliability of these repayment sources and conclude that knowledge of the market value of the real estate on which the lien will be taken as an abundance of caution is unnecessary in making the credit decision.

An institution should not invoke the abundance of caution exemption if its credit analysis reveals that the transaction would not be adequately secured by sources of repayment other than the real estate, even if the contributory value of the real estate collateral is low relative to the entire collateral pool and other repayment sources. Similarly, the exemption should not be applied to a loan or loan program unless the institution verifies and documents the primary and secondary repayment sources. In the absence of verification of the repayment sources, this exemption should not be used merely to reduce the cost associated with obtaining an appraisal, minimize transaction processing time, or offer slightly better terms to a borrower than would be otherwise offered.

In addition, prior to making a final commitment to the borrower, the institution should



document and retain in the credit file the analysis performed to verify that the abundance of caution exemption has been appropriately applied. If the operating performance or financial condition of the company subsequently deteriorates and the lender determines that the real estate will be relied upon as a repayment source, an appraisal should then be obtained, unless another exemption applies.

### 3. Loans Not Secured by Real Estate

An institution is not required to obtain an appraisal on a loan that is not secured by real estate, even if the proceeds of the loan are used to acquire or improve real property. For loans covered by this exemption, the real estate has no direct effect on the institution's decision to extend credit because the institution has no legal security interest in the real estate. This exemption is not intended to be applied to real estate-related financial transactions other than those involving loans. For example, this exemption should not be applied to a transaction such as an institution's investment in real estate for its own use.

### 4. Liens for Purposes Other Than the Real Estate's Value

This exemption allows an institution to take liens against real estate without obtaining an appraisal to protect legal rights to, or control over, other collateral. Institutions frequently take real estate liens to protect legal rights to other collateral rather than because of the contributory value of the real estate as an individual asset. For example, an institution making a loan to a logging operation may take a lien against the real estate upon which the timber stands to ensure its access to the timber in the event of default. To apply the exemption, the institution should determine that the market value of the real estate as an individual asset is not necessary to support its decision to extend credit.

### 5. Real Estate-Secured Business Loans

This exemption applies to business loans with a

transaction value of \$1 million or less when the sale of, or rental income derived from, real estate is not the primary source of repayment. To apply this exemption, the agencies expect the institution to determine that the primary source of repayment for the business loan is operating cash flow from the business rather than rental income or sale of real estate. For this type of exempted loan, under the agencies' appraisal regulations, an institution may obtain an evaluation in lieu of an appraisal.

This exemption will not apply to transactions in which the lender has taken a security interest in real estate, but the primary source of repayment is provided by cash flow or sale of real estate in which the lender has no security interest. For example, a transaction in which a loan is secured by real estate for one project, in which the lender has taken a security interest, but will be repaid with the cash flow from real estate sales or rental income from other real estate projects, in which the lender does not have a security interest, would not qualify for the exemption. (See "Appendix D—Glossary" in this section for a definition of business loan.)

### 6. Leases

An institution is required to obtain appraisals of leases that are the economic equivalent of a purchase or sale of the leased real estate. For example, an institution must obtain an appraisal on a transaction involving a capital lease, as the real estate interest is of sufficient magnitude to be recognized as an asset of the lessee for accounting purposes. Operating leases that are not the economic equivalent of the purchase or sale of the leased property do not require appraisals.

### 7. Renewals, Refinancings, and Other Subsequent Transactions

Under certain circumstances, renewals, refinancings, and other subsequent transactions may be supported by evaluations rather than appraisals. The agencies' appraisal regulations permit an evaluation for a renewal or refinancing of an existing extension of credit at the institution when either

1. there has been no obvious and material

- change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or
2. there is no advancement of new monies, other than funds necessary to cover reasonable closing costs.

A subsequent transaction is exempt from the appraisal requirement if no new monies are advanced (other than funds necessary to cover reasonable closing costs) even when there has been an obvious and material change in market conditions or the physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection. Conversely, when new monies are advanced (other than funds necessary to cover reasonable closing costs) and there has been an obvious and material change in market conditions or the physical aspects of the property that threaten the adequacy of the institution's real estate collateral protection, the institution must obtain an appraisal unless another exemption applies.

For the purposes of these guidelines, an institution is considered to have advanced new monies (excluding reasonable closing costs) when there is an increase in the principal amount of the loan over the amount of principal outstanding before the renewal or refinancing. For example, an institution originated a 15-year term loan for \$3 million and, in year 14, the outstanding principal is \$2.5 million. In year 14, the borrower seeks to refinance the loan at a lower interest rate and requests a loan of \$2.8 million. The \$300,000 would be considered new monies. On the other hand, an institution has provided a \$5 million revolving line of credit to a borrower for two years and, at the end of year two, renews the \$5 million line for another two years. At the time of renewal, the borrower has drawn down \$1 million. In this example, the amount of the line remains unchanged even though the amount available on the line is less than the line commitment. Renewing the line of credit at its original amount would not be considered an advancement of new monies. Further, when an institution advances funds to protect its interest in a property, such as to repair damaged property, a new appraisal or evaluation would not be required because these funds would be used to restore the damaged property to its original condition.

To satisfy the condition for no obvious and

material change in market conditions or the physical aspects of the property, the current or planned future use of the property should be consistent with the use identified in the existing appraisal or evaluation. For example, if a property has reportedly increased in value because of a planned change in use of the property resulting from rezoning, an appraisal should be performed unless another exemption applies.

If an evaluation is permitted under this exemption, an institution may use an existing appraisal or evaluation as long as the institution verifies and documents that the appraisal or evaluation continues to be valid. (See "Validity of Appraisals and Evaluations" in section 4140.1 of this manual for further discussion.) Even if a subsequent transaction qualifies for this exemption, an institution should consider the risk posed by the transaction and may wish to consider obtaining a new appraisal.

*Loan Workouts or Restructurings.* Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings and other subsequent transactions. Use of this exemption depends on meeting the conditions listed in (1) and (2) at the beginning of the discussion on "Renewals, Refinancings, and Other Subsequent Transactions." An institution also should consider such factors as the quality of the underlying collateral and the validity of the existing appraisal or evaluation.

If a loan workout involves acceptance of new real estate collateral that facilitates the orderly collection of the credit, or reduces the institution's risk of loss, an appraisal or evaluation of the existing and new collateral may be prudent, even if it is obtained after the workout occurs and the institution perfects its security interest.

## 8. Transactions Involving Real Estate Notes

This exemption applies to appraisal requirements for transactions involving the purchase, sale, investment in, exchange of, or extension of credit secured by a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities. If each note or real estate interest meets the agencies'



regulatory requirements for appraisals at the time the real estate note was originated, the institution need not obtain a new appraisal to support its interest in the transaction. The institution should employ audit procedures and review a representative sample of appraisals supporting pooled loans or real estate notes to determine that the conditions of the exemption have been satisfied.

Principles of safe and sound banking practices require an institution to determine the suitability of purchasing or investing in existing real estate-secured loans and real estate interests. These transactions should have been originated according to secondary market standards and have a history of performance. The information from these sources, together with original documentation, should be sufficient to allow an institution to make appropriate credit decisions regarding these transactions.

An institution may presume that the underlying loans in a marketable, mortgage-backed security satisfy the requirements of the agencies' appraisal regulations whenever an issuer makes a public statement, such as in a prospectus, that the appraisals comply with the agencies' appraisal regulations. A marketable security is one that may be sold with reasonable promptness at a price that corresponds to its fair value.

If the mortgages that secure the mortgage warehouse loan are sold to Fannie Mae or Freddie Mac, the sale itself may be used to demonstrate that the underlying loans complied with the agencies' appraisal regulations. In such cases, the agencies expect an institution to monitor its borrower's performance in selling loans to the secondary market and take appropriate steps, such as increasing sampling and auditing of the loans and the supporting documentation, if the borrower experiences more than a minimal rate of loans being put back by an investor.

## 9. Transactions Insured or Guaranteed by a U.S. Government Agency or U.S. Government-Sponsored Agency

This exemption applies to transactions that are wholly or partially insured or guaranteed by a U.S. government agency or U.S. government-sponsored agency. The agencies expect these

transactions to meet all the underwriting requirements of the federal insurer or guarantor, including its appraisal requirements, in order to receive the insurance or guarantee.

## 10. Transactions That Qualify for Sale to, or Meet the Appraisal Standards of, a U.S. Government Agency or U.S. Government-Sponsored Agency

This exemption applies to transactions that either

- (i) qualify for sale to a U.S. government agency or U.S. government-sponsored agency,<sup>1</sup> or
- (ii) involve a residential real estate transaction in which the appraisal conforms to Fannie Mae or Freddie Mac appraisal standards applicable to that category of real estate.

An institution may engage in these transactions without obtaining a separate appraisal conforming to the agencies' appraisal regulations. Given the risk to the institution that it may have to repurchase a loan that does not comply with the appraisal standards of the U.S. government agency or U.S. government-sponsored agency, the institution should have appropriate policies to confirm its compliance with the underwriting and appraisal standards of the U.S. government agency or U.S. government-sponsored agency.

- An institution that relies on exemption 10(i) should maintain adequate documentation that confirms that the transaction qualifies for sale to a U.S. government agency or U.S. government-sponsored agency. If the qualification for sale is not adequately documented, the transaction should be supported by an appraisal that conforms to the agencies' appraisal regulations, unless another exemption applies.
- To qualify for this exemption, transactions that do not conform to all Fannie Mae or Freddie Mac underwriting standards, such as jumbo or other residential real estate loans, must be supported by an appraisal that meets these government-sponsored agencies' appraisal standards for the applicable property

1. These government-sponsored agencies include Banks for Cooperatives, Federal Agriculture Mortgage Corporation, Federal Farm Credit Banks, Federal Home Loan Banks, Freddie Mac, Fannie Mae, and Tennessee Valley Authority.

type and is documented in the credit file or reproducible.

## 11. Transactions by Regulated Institutions as Fiduciaries

An institution acting as a fiduciary is not required to obtain appraisals under the agencies' appraisal regulations if an appraisal is not required under other laws governing fiduciary responsibilities in connection with a transaction. For example, if no other law requires an appraisal in connection with the sale of a parcel of real estate to a beneficiary of a trust on terms specified in a trust instrument, an appraisal is not required under the agencies' appraisal regulations. However, when a fiduciary transaction requires an appraisal under other laws, that appraisal should conform to the agencies' appraisal requirements.

## 12. Appraisals Not Necessary to Protect Federal Financial and Public Policy Interests or the Safety and Soundness of Financial Institutions

The agencies retain the authority to determine when the services of an appraiser are not required in order to protect federal financial and public policy interests or the safety and soundness of financial institutions. This exemption is intended to apply to individual transactions on a case-by-case basis rather than broad categories of transactions that would otherwise be addressed by an appraisal exemption. An institution would need to seek a waiver from its supervisory federal agency before entering into the transaction.

## APPENDIX B—EVALUATIONS BASED ON ANALYTICAL METHODS OR TECHNOLOGICAL TOOLS

*This appendix provides a discussion of the agencies' expectations for evaluations that are based on analytical methods and technological tools, including the use of automated valuation models and tax assessment valuations.*

The agencies' appraisal regulations permit an institution to use an evaluation in lieu of an

appraisal for certain transactions. An institution may use a variety of analytical methods and technological tools for developing an evaluation, provided the institution can demonstrate that the valuation method is consistent with safe and sound banking practices and the December 2010 Interagency Appraisal and Evaluation Guidelines (Interagency Guidelines) (see "Evaluation Development" and "Evaluation Content" in section 4140.1 of this manual for further discussion).<sup>2</sup> An institution should not select a method or tool solely because it provides the highest value, the lowest cost, or the fastest response or turnaround time.

An institution should establish policies and procedures that provide a sound process for using various methods or tools. Such policies and procedures should:

- Ensure staff has the requisite expertise and training to manage the selection, use, and validation of an analytical method or technological tool. If an institution does not have the in-house expertise relative to a particular method or tool, then an institution should employ additional personnel or engage a third party. (See "Third-Party Arrangements" in section 4140.1 of this manual.)
- Address the selection, use, and validation of the valuation method or tool.
- Establish criteria for determining whether a particular valuation method or tool is appropriate for a given transaction or lending activity, considering associated risks. These risks include, but are not limited to, transaction size and purpose, credit quality, and leverage tolerance (loan-to-value).
- Specify criteria when a market event or risk factor would preclude the use of a particular method or tool.
- Address standards for the use of multiple methods or tools, if applicable, for valuing the same property or to support a particular lending activity.
- Provide criteria for ensuring that the institution uses a method or tool that produces a reliable estimate of market value that supports the institution's decision to engage in a transaction.

<sup>2</sup> For example, the sole use of data from the Internet or other public sources would not be an evaluation under the Interagency Guidelines in section 4140.1. Additionally, valuation methods that do not contain sufficient information and analysis or provide a market value conclusion would not be acceptable as evaluations.

- Address the extent to which:
  - An inspection or research is necessary to ascertain the property’s actual physical condition and
  - Supplemental information is needed to assess the effect of market conditions or other factors on the estimate of market value.

An institution should establish an effective system of controls for verifying that a valuation method or tool is employed in a manner consistent with internal policies and procedures. Moreover, the institution’s staff responsible for internal controls should have the skills commensurate with the complexity or sophistication of the method or tool. Examiners will review an institution’s policies, procedures, and internal controls to ensure that an institution’s use of a method or tool is appropriate and consistent with safe and sound banking practices.

## AUTOMATED VALUATION MODELS

Automated valuation models (AVMs) are computer programs that estimate a property’s market value based on market, economic, and demographic factors. Institutions may employ AVMs for a variety of uses such as loan underwriting and portfolio monitoring. An institution may not rely solely on the results of an AVM to develop an evaluation unless the resulting evaluation is consistent with safe and sound banking practices and these guidelines. (See “Evaluation Development” and “Evaluation Content” in section 4140.1 of this manual.) For example, to be consistent with the standards for an evaluation, the results of an AVM would need to address a property’s actual physical condition and, therefore, could not be based on an unsupported assumption, such as a property that is in “average” condition.

Institutions should establish policies and procedures that govern the use of AVMs and specify the supplemental information that is required to develop an evaluation. When the supplemental information indicates the AVM is not an acceptable valuation tool, the institution’s policies and procedures should require the use of an alternative method or tool.

## Selecting AVMs

When selecting an AVM or multiple AVMs, an institution should:

- Perform the necessary level of due diligence on AVM vendors and their models, including how model developers conducted performance testing as well as the sample size used and the geographic level tested (such as, county level or zip code).
- Establish acceptable minimum performance criteria for a model prior to and independent of the validation process.
- Perform a detailed validation of the model(s) considered during the selection process and document the validation process.
- Evaluate underlying data used in the model(s), including the data sources and types, frequency of updates, quality control performed on the data, and the sources of the data in states where public real estate sales data are not disclosed.
- Assess modeling techniques and the inherent strengths and weaknesses of different model types (such as hedonic, index, and blended), as well as how a model(s) performs for different property types (such as condominiums, planned unit developments, and single family detached residences).
- Evaluate the vendor’s scoring system and methodology for the model(s). Determine whether the scoring system provides an appropriate indicator of model reliability by property types and geographic locations.

Following the selection of one or more AVMs, an institution should develop policies and procedures to address their appropriate use, monitoring, and ongoing validation processes.

## Determining AVM Use

An institution should establish policies and procedures for determining whether an AVM can be used for a particular transaction. The institution should

- Maintain AVM performance criteria for accuracy and reliability in a given transaction, lending activity, and geographic location.<sup>3</sup>

<sup>3</sup> For example, an institution should establish a level of

- Establish internal confidence score<sup>4</sup> minimums, or similar criteria, for when each model can be used.
- Implement controls to preclude “value shopping” when more than one AVM is used for the same property.
- Establish procedures for obtaining an appraisal or using a different valuation method to develop an evaluation when an AVM’s resulting value is not reliable to support the credit decision. For example, in areas that have experienced a high incidence of fraud, the institution should consider whether the AVM may be relied upon for the transaction or another valuation method should be used.
- Identify circumstances under which an AVM may not be used, including:
  - When market conditions warrant, such as during the aftermath of a natural disaster or a major economic event;
  - When a model’s performance is outside of specified tolerances for a particular geographic market or property price-tier range; or
  - When a property is nonhomogeneous, such as atypical lot sizes or property types.

development or sales functions. An institution should not rely solely on validation representations provided by an AVM vendor. An institution should perform appropriate model validation regardless of whether it relies on AVMs that are supported by value insurance or guarantees. If there are insurance or guarantee components of any particular AVM, the institution is responsible for understanding the extent and limitations of the insurance policy or guarantee, and the claim process and financial strength of the insurer.

An institution should ensure that persons who validate an AVM on an ongoing basis are independent of the loan production and collection processes and have the requisite expertise and training. In the AVM validation procedures, an institution should specify, at a minimum,

- expectations for an appropriate sample size,
- level of geographic analysis,
- testing frequency and criteria for re-testing,
- standards of performance measures to be used, and
- range of acceptable performance results.

To ensure unbiased test results, an institution should compare the results of an AVM to actual sales data in a specified trade area or market prior to the information being available to the model. If an institution uses more than one AVM, each AVM should be validated. To assess the effectiveness of its AVM practices, an institution should verify whether loans in which an AVM was used to establish value met the institution’s performance expectations relative to similar loans that used a different valuation process. An institution should document the results of its validation and audit findings. An institution should use these findings to analyze and periodically update its policies and procedures for an AVM when warranted.

## Validating AVM Results

An institution should establish standards and procedures for independent and ongoing monitoring and model validation, including the testing of multiple AVMs, to ensure that results are credible.<sup>5</sup> An institution should be able to demonstrate that the depth and extent of its validation processes are consistent with the materiality of the risk and the complexity of the transaction. Validation can be performed internally or with the assistance of a third party, as long as the validation is conducted by qualified individuals that are independent of the model

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acceptable core accuracy and limit exposure to a model’s systemic tendency to over value properties (commonly referred to as “tail risk”).

4. A “confidence score” generally refers to a vendor’s own method of quantifying how reliable a model value is by using a rank ordering process. The scale and components of a confidence score are not standardized. Therefore, an institution needs to understand how a confidence score was derived and the extent to which a confidence score correlates to model accuracy. If multiple AVMs are used, an institution should understand how the combination of models affects overall accuracy.

5. See, for example, OCC Bulletin 2000-16, “Risk Modeling—Model Validation” (May 30, 2000).

## TAX ASSESSMENT VALUATIONS

An institution may not rely solely on the data provided by local tax authorities to develop an evaluation unless the resulting evaluation is consistent with safe and sound banking practices and the Interagency Guidelines. (See “Evaluation Development” and “Evaluation Content” in section 4140.1 of this manual for further discussion.) Since analytical methods

such as tax assessment valuations (TAVs) generally need additional support to meet the Interagency Guidelines, institutions should develop policies and procedures that specify the level and extent of supplemental information that should be obtained to develop an evaluation. Such policies and procedures also should require the use of an alternate valuation method when such information does not support the transaction.

An institution may use a TAV in developing an evaluation when it can demonstrate that a valid correlation exists between the tax assessment data and the market value. In using a TAV to develop an evaluation, an institution should

- determine and document how the tax jurisdiction calculates the TAV and how frequently property revaluations occur,
- perform an analysis to determine the relationship between the TAV and the property market values for properties within a tax jurisdiction, and
- test and document how closely TAVs correlate to market value based on contemporaneous sales at the time of assessment and revalidate whether the correlation remains stable as of the effective date of the evaluation.

## APPENDIX C—DEDUCTIONS AND DISCOUNTS

*Appendix C is a discussion on appraisal standards for determining the market value of a residential tract development, including an explanation of the requirement to analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units.*

The agencies' appraisal regulations require an appraiser to analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units. For such transactions, an appraisal must include the market value of the property, which should reflect the property's actual physical condition, use, and zoning designation (referred to as the "as is" value of the property), as of the effective date of the appraisal. Therefore, if the highest and best use

of the property is for development to a different use, the cost of demolition and site preparation should be considered in the analysis.

### Proposed Construction or Renovation

For properties where improvements are to be constructed or rehabilitated, an institution may request a prospective market value upon completion and a prospective market value upon stabilization. While an institution may request the appraiser to provide the sum of retail sales for a proposed development, the result of such calculation is not the market value of the property for purposes of the agencies' appraisal regulations.

### Partially Leased Buildings

For proposed and partially leased rental developments, the appraiser must make appropriate deductions and discounts to reflect that the property has not achieved stabilized occupancy. The appraisal analysis also should include consideration of the absorption of the unleased space. Appropriate deductions and discounts should include items such as leasing commission, rent losses, tenant improvements, and entrepreneurial profit, if such profit is not included in the discount rate.

### Nonmarket Lease Terms

For properties subject to leases with terms that do not reflect current market conditions, the appraisal must clearly state the ownership interest being appraised and provide a discussion of the leases that are in place. If the leased fee interest is being appraised and contract rent is less than market rent on one or more long term lease(s) to a highly rated tenant, the market value of the leased fee interest would be less than the market value of the unencumbered fee simple interest in the property.<sup>6</sup> In these situa-

6. Fee simple interest refers to the most complete ownership unencumbered by any leases or other interests. It is subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat. Leased fee interest, on the other hand, refers to a landlord's ownership that is encumbered by one or more leases.



tions, the market value of the leased fee interest should be used.

## Tract Developments with Unsold Units

A tract development is defined in the agencies' appraisal regulations as a project of five units or more that is constructed or is to be constructed as a single development. Appraisals for these properties must reflect deductions and discounts for holding costs, marketing costs, and entrepreneurial profit supported by market data. In some cases entrepreneurial profit may be included in the discount rate. The applicable discount rate is developed based on investor requirements and the risk associated with the physical and financial characteristics of the property. In some markets, entrepreneurial profit is treated as a line item deduction while in other markets it is reflected as a component of the discount rate.

Regardless of how entrepreneurial profit is handled in the appraisal analysis, an appropriate explanation and discussion should be provided in the appraisal report. The projected sales prices and absorption rate of units should be supported by anticipated demand at the time the units are expected to be exposed for sale. Anticipated demand for the units should be supported and presented in the appraisal. A reader of the appraisal report should be able to understand the risk characteristics associated with the subject property and the market, including the anticipated supply of competing properties.

- *Raw Land.* The appraiser must provide an opinion of value for raw land based on its current condition and existing zoning. If an appraiser employs a developmental approach to value the land that is based on projected land sales or development and sale of lots, the appraisal must reflect appropriate deductions and discounts for costs associated with developing and selling lots in the future. These costs may be incurred during the permitting, construction, or selling stages of development. Appropriate deductions and discounts should include items such as feasibility studies, permitting, engineering, holding costs, marketing costs, and entrepreneurial profit and other costs specific to the property. If sufficient market data exist to perform both the sales

comparison and developmental approaches to value, the appraisal report should detail a reconciliation of these two approaches in arriving at a market value conclusion for the raw land.

- *Developed Lots.* For existing or proposed developments of five or more residential lots in a single development, the appraiser must analyze and report appropriate deductions and discounts. Appropriate deductions and discounts should reflect holding costs, marketing costs, and entrepreneurial profit during the sales absorption period for the sale of the developed lots. The estimated sales absorption period should reflect the appraiser's estimate of the time frame for the actual development and sale of the lots, starting on the effective date of value and ending as of the expected date of the last lot sale. The absorption period should be based on market demand for lots in light of current and expected competition for similar lots in the market area.
- *Attached or Detached Single-Family Homes.* For proposed construction and sale of five or more attached or detached single-family homes in the same development, the appraiser must analyze and report appropriate deductions and discounts. Appropriate deductions and discounts should reflect holding costs, marketing costs, and entrepreneurial profit during the sales absorption period of the completed units. If an institution finances construction on an individual unit basis, an appraisal of the individual units may be used if the institution can demonstrate through an independently obtained feasibility study or market analysis that all units collateralizing the loan can be constructed and sold within 12 months. However, the transaction should be supported by an appraisal that analyzes and reports appropriate deductions and discounts if any of the individual units are not completed and sold within the 12-month time frame.
- *Condominiums.* For proposed construction and sale of a condominium building with five or more units, the appraisal must reflect appropriate deductions and discounts. Appropriate deductions and discounts should include holding costs, marketing costs, and entrepreneurial profit during the sales absorption period of the completed units. If an institution finances construction of a single condominium building with less than five units or a condominium project with multiple buildings with less than five units per building, the institution may rely

on appraisals of the individual units if the institution can demonstrate through an independently obtained feasibility study or market analysis that all units collateralizing the loan can be constructed and sold within 12 months. However, the transaction should be supported by an appraisal that analyzes and reports appropriate deductions and discounts if any of the individual units are not completed and sold within the 12-month time frame.

## APPENDIX D—GLOSSARY

*Appendix D provides definitions of terms related to real estate lending, appraisals, and regulations to aid in the reading of the guidelines.*

**Agent.** The agencies' appraisal regulations do not specifically define the term "agent." However, the term is generally intended to refer to one who undertakes to transact business or manage business affairs for another. According to the agencies' appraisal regulations, fee appraisers must be engaged directly by the federally regulated institution or its agent,<sup>7</sup> and have no direct or indirect interest, financial or otherwise, in the property or transaction. The agencies do not limit the arrangements that federally regulated institutions have with their agents, provided those arrangements do not place the agent in a conflict of interest that prevents the agent from representing the interests of the federally regulated institution.

**Appraisal.** As defined in the agencies' appraisal regulations, a written statement independently and impartially prepared by a qualified appraiser (state licensed or certified) setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of relevant market information.

**Appraisal Management Company.** The agencies' appraisal regulations do not define the term appraisal management company. For purposes of these guidelines, an "appraisal management company" includes, but is not limited to, a third-party entity that provides real property

valuation-related services, such as selecting and engaging an appraiser to perform an appraisal based upon requests originating from a regulated institution. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) has a specific definition for this term in connection with transactions secured by a consumer's principal dwelling or mortgage secondary-market transactions. (See "Third-Party Arrangements" in section 4140.1 of this manual.)

**Appraisal Report Options.** Refer to the definitions for *Restricted Use Appraisal Report*, *Self-contained Appraisal Report*, and *Summary Appraisal Report*.

**Appraisal Threshold.** An appraisal is not required on transactions with a transaction value of \$250,000 or less. As specified in the agencies' appraisal regulations, an institution must obtain an evaluation of the real property collateral, if no other appraisal exemption applies.

**Approved Appraiser List.** A listing of appraisers who an institution has determined to be generally qualified and competent to perform appraisals and may address the appraiser's expertise in a particular market and property type.

**"As Completed" Market Value.** Refer to the definition for *Prospective Market Value*.

**"As Is" Market Value.** The estimate of the market value of real property in its current physical condition, use, and zoning as of the appraisal's effective date.

**"As Stabilized" Market Value.** Refer to the definition for *Prospective Market Value*.

**Automated Valuation Model.** A computer program that estimates a property's market value based on market, economic, and demographic factors. *Hedonic* models generally use property characteristics (such as square footage and room count) and methodologies to process information, often based on statistical regression. *Index* models generally use geographic repeat sales data over time rather than property characteristic data. *Blended or hybrid* models use elements of both hedonic and index models.

**Broker Price Opinion (BPO).** An estimate of the probable sales or listing price of the subject

7. Except that the regulated institution also may accept an appraisal that was prepared by an appraiser engaged directly by another financial services institution in certain circumstances as set forth in the agencies' appraisal regulations.

property provided by a real estate broker, sales agent, or sales person. A BPO generally provides a varying level of detail about a property's condition, market, and neighborhood, as well as comparable sales or listings. A BPO is not by itself an appraisal or evaluation, but could be used for monitoring the collateral value of an existing loan, when deemed appropriate. Further, the Dodd-Frank Act provides “[i]n conjunction with the purchase of a consumer's principal dwelling, broker price opinions may not be used as the primary basis to determine the value of a piece of property for the purpose of loan origination of a residential mortgage loan secured by such piece of property.”<sup>8</sup>

**Business Loan.** As defined in the agencies' appraisal regulations, a loan or extension of credit to any corporation, general or limited partnership, business trust, joint venture, syndicate, sole proprietorship, or other business entity. A business loan includes extensions to entities engaged in agricultural operations, which is consistent with the agencies' real estate lending guidelines definition of an improved property loan that includes loans secured by farmland, timberland, and ranchland committed to ongoing management and agricultural production.

**Business Loan Threshold.** A business loan with a transaction value of \$1,000,000 or less does not require an appraisal if the primary source of repayment is not dependent on the sale of, or rental income derived from, real estate. As specified in the agencies' appraisal regulations, an institution must obtain an evaluation of the real property collateral.

**Client.** According to the Uniform Standards of Professional Appraisal Practice (USPAP), the party or parties who engage(s) an appraiser by employment or contract for a specific appraisal assignment. For the purposes of these guidelines, the appraiser should be aware that the client is the regulated institution. (Refer to “Third-Party Arrangements” in section 4140.1 of this manual.)

**Credible (Appraisal) Assignment Results.** According to USPAP, credible means “worthy of belief” used in the context of the Scope of Work Rule. Under this rule, credible assignment results depend on meeting or exceeding both (1) the expectations of parties who are regularly

intended users for similar assignments and (2) what an appraiser's peers' actions would be in performing the same or a similar assignment.

**Credit File.** A hardcopy or electronic record that documents all information necessary to (1) analyze the credit before it is granted and (2) monitor the credit during its life. An institution may use a computerized or manual system to manage the information in its credit files.

**Date of the Appraisal Report.** According to USPAP, the date of the appraisal report indicates when the appraisal analysis was completed.

**Effective Date of the Appraisal.** USPAP requires that each appraisal report specifies the effective date of the appraisal and the date of the report. The date of the report indicates the perspective from which the appraiser is examining the market. The effective date of the appraisal establishes the context for the value opinion. Three categories of effective dates—retrospective, current, or prospective—may be used, according to the intended use of the appraisal assignment.

**Effective Date of the Evaluation.** For the purposes of the agencies' appraisal regulations and these guidelines, the effective date of an evaluation is the date that the analysis is completed.

**Engagement Letter.** An engagement letter between an institution and an appraiser documents the expectations of each party to the appraisal assignment. For example, an engagement letter may specify, among other items: (i) the property's location and legal description; (ii) intended use and users of the appraisal; (iii) the requirement to provide an opinion of the property's market value; (iv) the expectation that the appraiser will comply with applicable laws and regulations, and be consistent with supervisory guidance; (v) appraisal report format; (vi) expected delivery date; and (vii) appraisal fee.

**Evaluation.** A valuation permitted by the agencies' appraisal regulations for transactions that qualify for the appraisal threshold exemption, business loan exemption, or subsequent transaction exemption.

**Exposure Time.** As defined in USPAP, the estimated length of time the property interest

8. Dodd-Frank Act, section 1473(r).



being appraised would have been offered on the market prior to the hypothetical consummation of a sale at market value on the effective date of the appraisal. Exposure time is always presumed to precede the effective date of the appraisal. Exposure time is a function of price, time, and use—not an isolated opinion of time alone. (See USPAP Standard 1-2(c) and Statement 6.)

*Extraordinary Assumption.* As defined in USPAP, an assumption, directly related to a specific assignment, which, if found to be false, could alter the appraiser’s opinions or conclusions regarding the property’s market value. An example of an extraordinary assumption is when an appraiser assumes that an application for a zoning change will be approved and there is no evidence to suggest otherwise.

*Federally Regulated Institution.* For purposes of the agencies’ appraisal regulations and these guidelines, an institution that is supervised by a federal financial institutions regulatory agency. This includes a national or a state-chartered bank and its subsidiaries, a bank holding company and its non-bank subsidiaries, a federal savings association and its subsidiaries, a federal savings and loan holding company and its subsidiaries, and a credit union.

*Federally Related Transaction.* As defined in the agencies’ appraisal regulations, any real estate–related financial transaction in which the agencies or any regulated institution engages or contracts for, and that requires the services of, an appraiser.

*Financial Services Institution.* The agencies’ appraisal regulations do not contain a specific definition of the term “financial services institution.” The term is intended to describe entities that provide services in connection with real estate lending transactions on an ongoing basis, including loan brokers.

*Going Concern Value.* The value of a business entity rather than the value of the real property. The valuation is based on the existing operations of the business and its current operating record, with the assumption that the business will continue to operate.

*Hypothetical Condition.* As defined in USPAP, a condition that is contrary to what exists but is supposed for the purpose of analysis. An exam-

ple of a hypothetical condition is when an appraiser assumes a particular property’s zoning is different from what the zoning actually is.

*Loan-Production Staff.* Generally, all personnel responsible for generating loan volume or approving loans, as well as their subordinates and supervisors. These individuals would include any employee whose compensation is based on loan volume (such as processing or approving of loans). An employee is not considered loan-production staff just because part of their compensation includes a general bonus or profit-sharing plan that benefits all employees. Employees responsible solely for credit administration or credit-risk management are not considered loan-production staff.

*Marketing Time.* According to USPAP Advisory Opinion 7, the time it might take to sell the property interest at the appraised market value during the period immediately after the effective date of the appraisal. An institution may request an appraiser to separately provide an estimate of marketing time in an appraisal. However, this is not a requirement of the agencies’ appraisal regulations.

*Market Value.* As defined in the agencies’ appraisal regulations, the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition are the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby

- buyer and seller are typically motivated;
- both parties are well informed or well advised, and acting in what they consider their own best interests;
- a reasonable time is allowed for exposure in the open market;
- payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
- the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

*Presold Unit.* A unit may be considered presold if a buyer has entered into a binding contract to

purchase the unit and has made a substantial and non-refundable earnest money deposit. Further, the institution should obtain sufficient documentation that the buyer has entered into a legally binding sales contract and has obtained a written prequalification or commitment for permanent financing.

*Prospective Market Value “as Completed” and “as Stabilized.”* A prospective market value may be appropriate for the valuation of a property interest related to a credit decision for a proposed development or renovation project. According to USPAP, an appraisal with a prospective market value reflects an effective date that is subsequent to the date of the appraisal report. Prospective value opinions are intended to reflect the current expectations and perceptions of market participants, based on available data. Two prospective value opinions may be required to reflect the time frame during which development, construction, and occupancy will occur. The prospective market value “as completed” reflects the property’s market value as of the time that development is expected to be completed. The prospective market value “as stabilized” reflects the property’s market value as of the time the property is projected to achieve stabilized occupancy. For an income-producing property, stabilized occupancy is the occupancy level that a property is expected to achieve after the property is exposed to the market for lease over a reasonable period of time and at terms and conditions comparable to other similar properties. (See USPAP Statement 4 and Advisory Opinion 17.)

*Put Back.* Represents the ability of an investor to reject mortgage loans from a mortgage originator if the mortgage loans do not comply with the warranties and representations in their mortgage-purchasing agreement.

*Raw Land.* A parcel or tract of land with no improvements, for example, infrastructure or vertical construction. When an appraisal of raw land includes entitlements, the appraisal should disclose when such entitlements will expire if improvements are not completed within a specified time period and the potential effect on the value conclusion.

*Real Estate–Related Financial Transaction.* As defined in the agencies’ appraisal regulations, any transaction involving

- the sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing thereof;
- the refinancing of real property or interests in real property; or
- the use of real property or interests in property as security for a loan or investment, including mortgage-backed securities.

*Regulated Institution.* Refer to the definition for *Federally Regulated Institution*.

*Restricted Use Appraisal Report.* According to USPAP Standards Rule 2-2(c), a restricted use appraisal report briefly states information significant to solve the appraisal problem and includes references to the existence of specific work-file information in support of the appraiser’s opinions and conclusions. The agencies believe that the restricted use appraisal report will not be appropriate to underwrite a significant number of federally related transactions due to the lack of supporting information and analysis in the appraisal report. However, it may be appropriate to use this type of appraisal report for ongoing collateral monitoring of an institution’s real estate transactions and other purposes.

*Sales Concessions.* A cash or noncash contribution that is provided by the seller or other party to the transaction and reduces the purchaser’s cost to acquire the real property. A sales concession may include, but is not limited to, the seller paying all or some portion of the purchaser’s closing costs (such as prepaid expenses or discount points) or the seller conveying to the purchaser personal property which is typically not conveyed with the real property. Sales concessions do not include fees that a seller is customarily required to pay under state or local laws. In developing an opinion of market value, an appraiser must take into consideration the effect of any sales concessions on the market value of the real property. (See “Market Value” above and USPAP Standards Rule 1-2(c).)

*Sales History and Pending Sales.* According to USPAP Standards Rule 1-5, when the value opinion to be developed is market value, an appraiser must, if such information is available to the appraiser in the normal course of business, analyze: (1) all current agreements of sale, options, and listings of the subject property as of the effective date of the appraisal, and (2) all sales of the subject property that occurred within

three years prior to the effective date of the appraisal.

*Scope of Work.* According to the USPAP Scope of Work Rule, the type and extent of research and analyses in an appraisal assignment. (See the Scope of Work Rule in USPAP.)

*Self-contained Appraisal Report.* According to USPAP Standards Rule 2-2(a), a self-contained appraisal report is the most complete and detailed appraisal report option.

*Sum of Retail Sales.* A mathematical calculation of the sum of the expected sales prices of several individual properties in the same development to an individual purchaser. The sum of retail sales is not the market value for purposes of meeting the minimum appraisal standards in the agencies' appraisal regulations.

*Summary Appraisal Report.* According to USPAP Standards Rule 2-2(b), the summary appraisal report summarizes all information significant to the solution of an appraisal problem while still providing sufficient information to enable the client and intended user(s) to understand the rationale for the opinions and conclusions in the report.

*Tract Development.* As defined in the agencies' appraisal regulations, a project of five units or more that is constructed or is to be constructed as a single development. For purposes of these guidelines, "unit" refers to: a residential or commercial building lot, a detached single-family home, an attached single-family home, and a residence in a condominium, cooperative, or time-share building.

*Transaction Value.* As defined in the agencies' appraisal regulations:

- for loans or other extensions of credit, the

amount of the loan or extension of credit;

- for sales, leases, purchases, and investments in or exchanges of real property, the market value of the real property interest involved; and
- for the pooling of loans or interests in real property for resale or purchase, the amount of the loan or market value of the real property calculated with respect to each such loan or interest in real property.

For purposes of this definition, the transaction value for loans that permit negative amortization should be the institution's total committed amount, including any potential negative amortization.

*Uniform Standards of Professional Appraisal Practice (USPAP).* USPAP identifies the minimum set of standards that apply in all appraisal, appraisal review, and appraisal consulting assignments. These standards are promulgated by the Appraisal Standards Board of the Appraisal Foundation and are incorporated as a minimum appraisal standard in the agencies' appraisal regulations.

*Unsold Units.* An unsold unit is a unit that does not meet the conditions listed in the definition of *Presold Units*.

*Value of Collateral (for Use in Determining Loan-to-Value Ratio).* According to the agencies' real estate lending standards guidelines, the term "value" means an opinion or estimate set forth in an appraisal or evaluation, whichever may be appropriate, of the market value of real property, prepared in accordance with the agencies' appraisal regulations and the December 2010 Interagency Guidelines in section 4140.1. For loans to purchase an existing property, "value" means the lesser of the actual acquisition cost or the estimate of value.

# Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System

Effective date May 1997

Section A.5020.1

## OVERVIEW

Since 1979, state member banks have been rated using the interagency Uniform Financial Institutions Ratings System (UFIRS), which was recommended by the Federal Reserve and other banking agencies. This rating system, referred to industry-wide by the acronym CAMEL, evaluated five components: capital adequacy, asset quality, management and administration, earnings, and liquidity.

Over the years, the UFIRS has proven to be an effective internal supervisory tool for uniformly evaluating the soundness of financial institutions and for identifying those institutions requiring special attention or concern. Recently, the UFIRS was revised and updated to address changes in the financial services industry and in supervisory policies and procedures. The revisions include the addition of a sixth component addressing sensitivity to market risks, explicit reference to the quality of risk-management processes in the management component, and identification of risk elements within the composite and component rating descriptions.

The revisions to UFIRS are not intended to add to the regulatory burden of institutions nor require additional policies or processes. Instead, they are intended to promote and complement efficient examination processes. The revisions have been made to update the rating system, while retaining the basic framework of the original system.

The UFIRS considers certain financial, managerial, and compliance factors that are common to all institutions. Under this system, the supervisory agencies endeavor to ensure that all financial institutions are evaluated comprehensively and uniformly and that supervisory attention is appropriately focused on the financial institutions exhibiting financial and operational weaknesses or adverse trends.

The UFIRS is a useful vehicle for identifying problem or deteriorating financial institutions, as well as for categorizing institutions with deficiencies in particular component areas. Further, the rating system helps Congress follow safety-and-soundness trends and assess the aggregate strength and soundness of the financial industry, which helps the federal banking agencies in fulfilling their collective mission of

maintaining stability and public confidence in the nation's financial system.

## COMPOSITE RATINGS

Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of its financial condition and operations. These component factors address the adequacy of capital, quality of assets, capability of management, quality and level of earnings, adequacy of liquidity, and sensitivity to market risk. Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1-to-5 numerical scale. A "1" is the highest rating, indicating the strongest performance and risk-management practices and the least degree of supervisory concern. A "5" is the lowest rating, indicating the weakest performance, inadequate risk-management practices, and the highest degree of supervisory concern.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors that make up that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

The ability of management to respond to changing circumstances and address the risks that may arise from changing business conditions or the initiation of new activities or products is an important factor in evaluating a financial institution's overall risk profile, as well as the level of supervisory attention warranted. For this reason, the management component is given

special consideration when assigning a composite rating.

Furthermore, the ability of management to identify, measure, monitor, and control the risks of its operations is taken into account when assigning each component rating. Examiners should recognize, however, that appropriate management practices vary considerably among financial institutions, depending on their size, complexity, and risk profile. For less complex institutions engaged solely in traditional banking activities and whose directors and senior managers, in their respective roles, are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. At more complex institutions, detailed and formal management systems and controls are needed to address their broader range of financial activities and to provide senior managers and directors, in their respective roles, with the information they need to monitor and direct day-to-day activities. All institutions are expected to properly manage their risks. For less complex institutions engaging in less sophisticated risk-taking activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

Examiners consider foreign branch and specialty examination findings and the ratings assigned to those areas, as appropriate, when assigning component and composite ratings under UFIRS. The specialty examination areas include Compliance, Community Reinvestment, Government Security Dealers, Information Systems, Municipal Security Dealers, Transfer Agent, and Trust.

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk. The rating scale ranges from 1 to 5, with a rating of 1 indicating the strongest performance and risk-management practices, relative to the institution's size, complexity, and risk profile, and the level of least supervisory concern. A rating of 5 indicates the most critically deficient level of performance; inadequate risk-management practices relative to the institution's size, complexity, and risk profile; and the level

of greatest supervisory concern. The composite ratings are defined below.

### Composite 1

Financial institutions with a composite 1 rating are sound in every respect and generally have components rated 1 or 2. Any identified weaknesses are minor and can be handled routinely by the board of directors and management. These financial institutions are the most capable of withstanding fluctuating business conditions and are resistant to outside influences, such as economic instability in their trade area. These institutions are in substantial compliance with laws and regulations. As a result, they exhibit the strongest performance and risk-management practices relative to their size, complexity, and risk profile, and give no cause for supervisory concern.

### Composite 2

Financial institutions with a composite 2 rating are fundamentally sound. For a financial institution to receive this rating, generally none of its component ratings should be more severe than 3. Only moderate weaknesses are present, and the board of directors and management are capable of and willing to correct them. These financial institutions are stable, can withstand business fluctuations, and are in substantial compliance with laws and regulations. Overall risk-management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

### Composite 3

Financial institutions with a composite 3 rating exhibit some degree of supervisory concern in one or more of the component areas. These institutions have a combination of moderate to severe weaknesses; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness

to effectively address weaknesses within appropriate timeframes. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk-management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure of the institution appears unlikely, however, given its overall strength and financial capacity.

## Composite 4

Financial institutions with a composite 4 rating generally exhibit unsafe and unsound practices or conditions. They have serious financial or managerial deficiencies that result in unsatisfactory performance. The institution's problems range from severe to critically deficient, and weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk-management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means formal enforcement action is necessary in most cases to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure of the institution is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

## Composite 5

Financial institutions with a composite 5 rating exhibit extremely unsafe and unsound practices or conditions. Their performance is critically deficient and risk-management practices are inadequate relative to the institution's size, complexity, and risk profile. These institutions are of the greatest supervisory concern. The volume and severity of problems are beyond

management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and their failure is highly probable.

## COMPONENT RATINGS

Each of the component rating descriptions below lists the principal evaluation factors that relate to that component and briefly describes each numerical rating for that component. Some of the evaluation factors appear under one or more of the other components to illustrate the interrelationship among the components. The evaluation factors for each component are not listed in any particular order.

### Capital Adequacy

A financial institution is expected to maintain capital commensurate with its risks and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the need to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences of these risks on the institution's capital.

The capital adequacy of an institution is rated based on, but not limited to, an assessment of the following evaluation factors:

- the level and quality of capital and the overall financial condition of the institution
- the ability of management to address emerging needs for additional capital
- the nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves
- balance-sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities

- risk exposure represented by off-balance-sheet activities
- the quality and strength of earnings, and the reasonableness of dividends
- prospects and plans for growth, as well as past experience in managing growth
- access to capital markets and other sources of capital, including support provided by a parent holding company

### Ratings

1—A rating of 1 indicates a strong capital level relative to the institution's risk profile.

2—A rating of 2 indicates a satisfactory capital level relative to the institution's risk profile.

3—A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

4—A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.

5—A rating of 5 indicates a critically deficient level of capital. The institution's viability is threatened, and immediate assistance from shareholders or other external sources of financial support is required.

### Asset Quality

The asset-quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, other assets, and off-balance-sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses and weigh the institution's exposure to counterparty, issuer, or borrower default under actual or implied contractual agreements. All other risks

that may affect the value or marketability of an institution's assets, including but not limited to operating, market, reputation, strategic, or compliance risks, should be considered.

The asset quality of a financial institution is rated based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of underwriting standards, soundness of credit-administration practices, and appropriateness of risk-identification practices
- the level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance-sheet transactions
- the adequacy of the allowance for loan and lease losses and other asset valuation reserves
- the credit risk arising from or reduced by off-balance-sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit
- the diversification and quality of the loan and investment portfolios
- the extent of securities underwriting activities and exposure to counterparties in trading activities
- the existence of asset concentrations
- the adequacy of loan and investment policies, procedures, and practices
- the ability of management to properly administer its assets, including the timely identification and collection of problem assets
- the adequacy of internal controls and management information systems
- the volume and nature of credit-documentation exceptions

### Ratings

1—A rating of 1 indicates strong asset-quality and credit-administration practices. Identified weaknesses are minor and risk exposure is modest in relation to capital protection and management's abilities. Asset quality is of minimal supervisory concern.

2—A rating of 2 indicates satisfactory asset-quality and credit-administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.

3—A rating of 3 is assigned when asset-quality or credit-administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit-administration and risk-management practices.

4—A rating of 4 is assigned to financial institutions with deficient asset-quality or credit-administration practices. The levels of risk and problem assets are significant and inadequately controlled, and they subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

5—A rating of 5 represents critically deficient asset-quality or credit-administration practices that present an imminent threat to the institution's viability.

## Management

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities, and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk-exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of

an appropriate audit program and internal control environment; and effective risk-monitoring and management information systems. This rating should reflect the board's and management's ability in relation to all aspects of banking operations as well as other financial-service activities the institution is involved in.

The capability and performance of management and the board of directors is rated based on, but not limited to, an assessment of the following evaluation factors:

- the level and quality of oversight and support of all institution activities by the board of directors and management
- the ability of the board of directors and management, in their respective roles, to plan for and respond to risks that may arise from changing business conditions or the initiation of new activities or products
- the adequacy of and conformance with appropriate internal policies and controls addressing the operations and risks of significant activities
- the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems appropriate for the institution's size, complexity, and risk profile
- the adequacy of audits and internal controls to promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies
- compliance with laws and regulations
- responsiveness to recommendations from auditors and supervisory authorities
- management depth and succession
- the extent that the board of directors and management are affected by or susceptible to dominant influence or concentration of authority
- reasonableness of compensation policies and avoidance of self-dealing
- demonstrated willingness to serve the legitimate banking needs of the community
- the overall performance of the institution and its risk profile

## Ratings

1—A rating of 1 indicates strong performance by management and the board of directors and strong risk-management practices relative to the



institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

2—A rating of 2 indicates satisfactory management and board performance and risk-management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but they are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

3—A rating of 3 indicates management and board performance that needs improvement or risk-management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

4—A rating of 4 indicates deficient management and board performance or risk-management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

5—A rating of 5 indicates critically deficient management and board performance or risk-management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk-management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

## Earnings

The earnings rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the allowance for loan and lease losses. High levels of market risk may unduly expose the institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

The rating of an institution's earnings is based on, but not limited to, an assessment of the following evaluation factors:

- the level of earnings, including trends and stability
- the ability to provide for adequate capital through retained earnings
- the quality and sources of earnings
- the level of expenses in relation to operations
- the adequacy of the budgeting systems, forecasting processes, and management information systems in general
- the adequacy of provisions to maintain the allowance for loan and lease losses and other valuation allowance accounts
- the exposure of earnings to market risk such as interest-rate, foreign-exchange, and price risks

## Ratings

1—A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

2—A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to

asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

3—A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

4—A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. These institutions may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

5—A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

## Liquidity

In evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds-management practices relative to the institution's size, complexity, and risk profile. In general, funds-management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds-management practices should ensure that

liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Liquidity is rated based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of liquidity sources compared with present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition
- the availability of assets readily convertible to cash without undue loss
- access to money markets and other sources of funding
- the level of diversification of funding sources, both on- and off-balance-sheet
- the degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer-term assets
- the trend and stability of deposits
- the ability to securitize and sell certain pools of assets
- the capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds-management strategies, liquidity policies, management information systems, and contingency funding plans

## Ratings

1—A rating of 1 indicates strong liquidity levels and well-developed funds-management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

2—A rating of 2 indicates satisfactory liquidity levels and funds-management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds-management practices.

3—A rating of 3 indicates liquidity levels or funds-management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may show significant weaknesses in funds-management practices.

4—A rating of 4 indicates deficient liquidity levels or inadequate funds-management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

5—A rating of 5 indicates liquidity levels or funds-management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

## Sensitivity to Market Risk

The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this component, consideration should be given to management's ability to identify, measure, monitor, and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to the level of market-risk exposure.

For many institutions, the primary source of market risk arises from nontrading positions and their sensitivity to changes in interest rates. In some larger institutions, foreign operations can be a significant source of market risk. For other institutions, trading activities are a major source of market risk.

Market risk is rated based on, but not limited to, an assessment of the following evaluation factors:

- the sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign-exchange rates, commodity prices, or equity prices
- the ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile
- the nature and complexity of interest-rate risk exposure arising from nontrading positions
- where appropriate, the nature and complexity of market-risk exposure arising from trading and foreign operations

## Ratings

1—A rating of 1 indicates that market-risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk-management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.

2—A rating of 2 indicates that market-risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk-management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

3—A rating of 3 indicates that control of market-risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk-management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.

4—A rating of 4 indicates that control of market-risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk-management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

5—A rating of 5 indicates that control of market-risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability. Risk-management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

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